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Employee share options: the taxing uncertainty
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The global economic crisis has brought with it a close scrutiny of all manner of executive and employee remuneration arrangements. However, in the context of employee option plans, one of the most contentious and vexing issues for a recipient of options under an employee option plan is whether to elect to pay tax upfront on the value of the options under s 139E of the ITAA 1936 or defer the tax until exercise of the options.

The common belief among the 'uninitiated' is that by electing to pay income tax upfront on the acquisition of options, an employee will pay CGT on the disposal of the shares acquired from the exercise of the options and automatically receive the benefit of the 50% tax exemption afforded capital assets held for more than 12 months.

However, the truth in respect of options exercised into shares is not quite as simple as that.

According to the AAT's decision in *AAT Case [2002] AATA 1313, Re 'VAN' and FCT* (2002) 51 ATR 1153, where an employee makes a s 139E election, acquires the shares under the so-called 'cashless' exercise of option, and instructs the broker to sell immediately, the resultant capital profit will be taxed at the employee's full marginal tax rate, irrespective of how long he or she has held the options.

In effect, the taxpayer will have prepaid the CGT upfront, without accessing the benefit of the 50% tax exemption as a discount capital gain.

That is, notwithstanding that the employee may have held the options for several years and has paid tax upfront on the acquisition of the options, if the shares acquired as a result of the exercise of the options have not been held for more than 12 months, as required under the provisions of Div 115 of the ITAA 1997, any capital profit will be subject to the taxpayer's marginal income tax rate.

Van's case

In *Van's* case, the recipient of the share options was a non-executive director of a publicly listed company. On 12 August 1996, he was issued 500,000 options to shares, with a life of 4 years and an exercise price of $1.50.

The taxpayer made a s 139E election to be taxed upfront in the income tax year ended 30 June 1997. The options had a taxable value of $68,190, which he included in his assessable income. Between 7 December and 2 March 2000, the taxpayer exercised 226,666 options to subscribe for shares, for which he would pay a total exercise price of $339,999.

Option exercise

Between 8 December 1999 and 31 March 2000, the taxpayer sold 120,666 of the shares acquired for which he had paid a total options exercise price of $180,999 (ie 120,666 x $1.50 = $180,999).

Income tax return

After deducting the cost base of $197,455 (ie made up of the exercise price of $180,999 and the s 139E taxable value determined under s 139FC of the ITAA 1936 of $16,456) from the share sale proceeds of $569,637, the taxpayer returned a net capital gain of $372,182 in his assessable income for the year ended 30 June 2000.

The taxpayer then objected to the notice of assessment for the year ended 30 June 2000 on the grounds that the date of acquisition of the shares was the date of the acquisition of the options, and he was entitled to reduce the capital gain by 50% as the shares had been held for a period greater than 12 months.

Issue in dispute

The sole issue in dispute concerned the date the contract was entered into for the acquisition of the 120,666 shares disposed of in the year ended 30 June 2000.

Was the contract entered into:

1. when the options were acquired on August 1996, as contended by the taxpayer? or
2. when the options were exercised and shares were allotted on December 1999 and March 2000 (as contended by the Commissioner)?

If the answer were to be 1, the taxpayer would be entitled to halve the assessable profit on the sale of the shares (refer s 109-10 of the ITAA 1997).

If the answer were to be 2, the taxpayer would pay the full amount of tax, as if the capital profit were taxed as ordinary assessable income.

What is an option?

The Tribunal (at para 9), to its credit, did consider the legal nature of an option - which remains a legal 'chestnut' and the subject of ongoing legal controversy.

While most employees know exactly what an option to purchase shares (ie a call option) is, traditionally, the Australian and UK courts have not exhibited the same degree of certainty. The

courts have found options difficult to fit into the standard contractual, common law framework of offer, acceptance and consideration.

One judicial view is that it is a *conditional contract* for sale of property (ie in this case, a chose in action, being a share) (refer Griffith CJ in *Goldsborough, Mort & Co Ltd v Quinn* (1910) 10 CLR 674 at 678).

The other judicial view is that it is an *irrevocable offer*, extending over the life of the option (refer Latham CJ in *Commissioner of Taxes (Q) v Camphin* (1910) 10 CLR 674 at 678).

In *Laybutt v Amoco Australia Pty Ltd* (1974) 132 CLR, in the context of an option to purchase land, Gibb J came down in favour of the option being a conditional contract of purchase (at p 76).

The Tribunal in *Van's* case (at para 11) referred to the case of *Sydney Futures Exchange Ltd v Australian Stock Exchange Ltd & Anor* (1995) 128 ALR 417, where Gummow J ruled (at 544):

- that the usual polarised characterisations of 'irrevocable offer' and 'conditional contract' were not in fact mutually inconsistent concepts; and
- each characterisation was valid given the particular context, *particularly the statutory context*, in which they were being considered.

Section 160U(3) of the ITAA 1936

Under the former provisions of s 160U(3) (now ss 104-5 and 109-5 of the ITAA 1997), the asset is taken to have been acquired at the time of the making of the contract.

Character of the option agreement

In the context of the circumstances of this case, the Tribunal (at para 13) was of the view that the option agreement was characterised as an irrevocable offer in that it was,

'…an offer together with a contract that the offer will not be revoked during the time specified in the option.'

Therefore, finally, the Tribunal concluded (at para 13) that the date of the relevant contract for the acquisition of the shares for the purposes of s 109-10 of the ITAA 1997 was the date when the taxpayer applied for and was allotted the shares - and *not* before that date.

The Tribunal (at para 13) made the general observation that,

'It is clear that a share when allotted is a completely different chose in action and asset to the chose in action and asset of an option.'

Section 160ZYV(1) of the ITAA 1936

Finally, the Tribunal referred to s 160ZYV(1), which states quite unequivocally that,

'When the option is exercised, …the person shall be deemed, for the purposes of this Part [IIIA], to have acquired the new shares at the time when the option was exercised.'

These principles have been followed in the subsequent provisions of ss 130-45(2) and 130-50 of the ITAA 1997, which also state quite unequivocally that,

'you are taken to have acquired the new shares when you exercise the rights [or options].'

Comments

Sale of shares

It is clear that if a taxpayer makes a s 139E election to be taxed upfront and the taxpayer exercises the options and acquires shares, the taxpayer must hold the *shares* for more than 12 months before the taxpayer is eligible to treat the sale of shares as a discount capital gain under the provisions of Div 115 of the ITAA 1997, irrespective of how long they had held the options.

Margin loans

In the past, certain stockbroking firms and banks were keen to assist employees with margin lending arrangements to facilitate the holding of the shares, for the mandatory 12 month period.

Given the protracted bull share market conditions existing worldwide until around October 2008, these margin lending arrangements, generally speaking, worked well.

However, since the share market crash in October 2008, the dramatic fall in share values meant that some margin loans on shares issued before the crash were called in, employees lost their shares and any inherent capital gain to be made on the sale of those shares.

Had the above employees retained their options unexercised, and the share values had fallen, employees could have had their worthless options cancelled or 'allowed them to lapse', and 'clawed back' the income tax paid previously on the s 139E election to be taxed upfront, under the provisions of s 139DD of the ITAA 1936.

However, once the options have been exercised into shares, employees have no capacity to 'claw back' the income tax paid previously in respect of the s 139E election to be taxed upfront.

They may have now realised capital losses to be carried forward and applied against future capital gains, in a share market now more volatile than it has been for the past 15 years.

Option disposal

In the context of *Van's* case and the taxpayer making the s 139E election, had the option plan allowed the taxpayer to sell the vested options (ie instead of the shares), or allowed the options

to be cancelled prior to exercise for their full market value and the options had been held for more than 12 months, the capital profit on the sale of the options would be subject to the 50% discount capital gains exemption.

Conclusion

Fortunately, some companies have implemented share plans that:

- do not lumber employees with upfront tax liabilities;
- time the employees' tax trigger to coincide with the sale of the shares;
- allow employees to retain their equity after termination of employment, subject to the appropriate vesting conditions, without triggering taxation liabilities prior to the disposal of the options or shares;
- provide employees with the appropriate advice concerning the taxation consequences of the acquisition, exercise and disposal of their options and shares; and
- do not require employees to lock themselves into potentially high risk and expensive margin lending arrangements.

Given the current push for enhanced employee and shareholder alignment and the ever increasing requirement for company equity to be provided as a key component of employee reward at all levels of the organisation, it is critical that companies optimise design, delivery and management of that employee equity participation.

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