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WEEKLY TAX BULLETIN

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Issue 31, 24 JULY 2009

Employee share plans: on the bright side

- by Gary Fitton, Director, Remuneration Strategies Group

In all of the hullabaloo of shock, horror and outraged reactions to the Treasurer's surprise 2009 Budget night announcement that all discounted employee share and option benefits would be taxed upfront, lost in that commotion are some enlightened and positive Government proposals to improve and assist employees with taking up shares and options in their employer companies.

Not only has the Government:

- raised the adjusted taxable income threshold to \$180,000 per annum for the qualifying \$1,000 tax-exempt discounts;
- introduced a new salary sacrifice share plan, capped at discounts of \$5,000 per annum;
- extended the provisions allowing deferral of the taxing point for discounts on shares and options, where there is a 'genuine risk of forfeiture' and restrictions on disposal for a period of up to 7 years; and
- extended the application date of the new proposals to 1 July 2009,

but, under the Government's proposals, all the 3 tax concessional plans can be provided, jointly, in the same year of tax, without employees being subject to confusing decisions about s 139E elections each year.

Existing provisions

Under the provisions of Div 13A of the ITAA 1936, if employees wished to avail themselves of the \$1,000 tax-exempt shares, the s 139E election to be taxed upfront would apply to all *other* acquisitions by the employee of shares and/or options during that tax year, which would be taxed upfront, without the tax exemption and/or the tax deferral.

Improved plan compatibility

If the Government's proposals become law, from 1 July 2009, the concessions of tax exemption and/or tax deferral of discounts on shares and options will become plan-based, rather than employee election-based. That is, so long as the shares and options offered to employees under the various plans meet the tax exemption and tax deferral requirements, all the qualifying plans will become mutually compatible and can be provided contemporaneously in the same year of tax and retain their respective tax-exempt and tax-deferred status.

Under the Government's amended proposal, in respect of each year of tax, employees can:

- accept the offer of \$1,000 qualifying tax-exempt share discounts;
- salary sacrifice an additional \$5,000 worth of qualifying tax-deferred share discounts; and
- accept an additional (and unlimited) offer of qualifying tax-deferred share and option discounts as long-term or short-term incentives, subject to genuine forfeiture conditions and restrictions on disposal for a tax deferral period of up to 7 years or earlier termination of employment.

Under the amended proposals, both listed and unlisted companies will be able to provide their employees with highly effective employee share plans that access both the \$1,000 tax-exempt discounts and tax-deferral discounts in the same year of tax. This is actually providing a *more* attractive, compatible and concessional qualifying taxation environment for the provision of discounted equity to employees, than the qualifying taxation environment that applied prior to 1 July 2009.

Example 1: Small Mining Company

Mia works as an engineer for a small Australian mining company (SMC), listed on the ASX, but in its initial exploration phases. She earns \$90,000 salary per annum. On 20 July 2009, SMC offers Mia:

- \$1,000 worth of tax-exempt share discounts;
- \$5,000 worth of salary sacrifice share discounts; and
- \$50,000 worth of shares subject to a vesting period of 3 years, with a genuine risk of forfeiture and restrictions on disposal.

Division 13A treatment

Under Div 13A, if Mia lodged a s 139E election, she would need to pay tax upfront for the tax year ended 30 June 2010 ie income tax of \$21,725 ($\$55,000 \times .395 = \$21,725$) on the salary sacrifice and long-term incentive share discounts.

Mia would probably only have taken up the \$1,000 tax-exempt share discounts, because she could not afford to pay the \$21,725 income tax on the take-up of the salary sacrifice and long-term incentive shares.

If Mia makes no s 139E election, the intended tax-exempt share discounts would lose their tax exemption and become tax-deferred share discounts for a maximum period of 3 years. The salary sacrifice share discounts and long-term incentive share discounts would retain their tax deferral status.

Proposed Div 83A of the ITAA 1997

Under the Government's proposed Div 83A provisions, there will be no s 139E election decisions to be made and no income tax to be paid upfront. Mia can then afford to take up *all* the shares offered to her by SMC, as the different plans will be mutually compatible in the particular year of tax.

The \$1,000 tax-exempt shares discounts would retain their tax-exempt status.

The \$5,000 worth of salary sacrifice share discounts and the \$50,000 worth of long-term incentive share discounts would be tax-deferred for a maximum period of 7 years or earlier termination of employment.

This would give Mia a total remuneration of \$141,000 comprising:

- salary of \$85,000;
- tax-exempt share discounts of \$1,000;
- salary sacrifice share discounts of \$5,000; and
- long-term incentive share discounts of \$50,000.

From the company's perspective, it has a key employee:

- taking up \$6,000 worth of fully vested shares in the company; and
- accepting a further \$50,000 worth of shares as a long-term retention/incentive,

while incurring no cash outflow.

This has aligned Mia's working goals with the goals of the SMC and its shareholders and retained valuable cash resources within SMC for expenditure on further mining exploration and capital development.

Example 2: Large Manufacturing Company

Prior to 1 July 2009, a large overseas company, listed on the New York Stock Exchange, with extensive manufacturing operations in Australia, introduced a qualifying \$1,000 tax-exempt share plan, which was accepted by most of its Australian employees. A few months later, selected employees were offered options from the overseas parent company, in addition to the tax-exempt shares.

As the selected employees had already accepted the \$1,000 tax-exempt share discounts and made the s 139E election to be taxed upfront, they would have been automatically taxed

upfront on the options. This meant that the employees were unable to accept the offer of the options, as they could not afford to pay the tax liability upfront.

Under the Government's proposal from 1 July 2009, the employees could accept offers under both the qualifying \$1,000 tax-exempt plan and the qualifying tax-deferred option plan in the same year of tax. The employee would not be required to make any tax elections, would not be taxed upfront and would enjoy both the qualifying tax-exempt *and* tax-deferred benefits in the same year of tax.

Example 3: Small Listed Company

A small listed company was offering qualifying tax-deferred, performance share rights to selected employees and, in addition, it was offering a qualifying deferred share plan on a salary sacrifice basis.

However, the company was unprepared to offer the \$1,000 tax-exempt plan, because employees would have been required to make the s 139E election to be taxed upfront. This election would have enabled its employees to access the annual \$1,000 tax-exempt share discount benefits, but would have rendered the qualifying tax-deferred plans taxable upfront, when the share rights were acquired.

Under the changes proposed from 1 July 2009, the company can offer all its employees the \$1,000 annual tax-exempt benefits, without undermining the qualifying tax-deferred benefits provided under the additional share plans.

Example 4: Large Unlisted Company

A large unlisted company operating in Australia and New Zealand offered all its employees tax-exempt share benefits (ie up to \$1,000 per annum in Australia and NZ\$780 per annum in New Zealand), in addition to tax-deferred share and option benefits to selected senior employees in Australia and New Zealand.

However, the company advised its selected senior Australian employees not to accept the tax-exempt share offer, as it was not compatible with its tax-deferred share and option offers.

The company can now offer its Australian employees the annual qualifying \$1,000 tax-exempt share benefits and the tax-deferred share benefits in the same year of tax.

In effect, Australia has simply caught up to the New Zealand exempt and deferred taxation treatments, which were mutually compatible and never required employees to lodge elections to be taxed upfront. This will make the plans far simpler to communicate and administer for the company and its employees in both tax jurisdictions.

Conclusion

While the Government's share plan proposals could have been handled better in terms of the earlier consultation with affected industry parties and in determining an appropriate result,

some of the original proposals actually improve the effectiveness of employee share benefits throughout the whole corporate hierarchy.

This is especially the case with the proposal to remove the employee's s 139E upfront tax election and to make the tax-exempt and tax-deferred share concessions purely plan based. This proposed amendment makes the various qualifying exempt and deferred share plans mutually compatible, far easier to communicate and administer and will assist to maximise employee participation in employee share plans across the board in all companies.

[Gary Fitton is author of the "Salary packaging and remuneration strategies" and "FBT and financial planning" chapters of the **Thomson Reuters Australian Financial Planning Handbook.**]