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Options in a time warp

- by Gary Fitton, Director, Remuneration Strategies Group Pty Ltd

The enactment of the employee share scheme changes in the *Tax Laws Amendment (2009 Budget Measures No 2) Act 2009* means that companies, employees and their advisers now have sufficient degree of certainty to amend, reinstate or replace employee share plans affected by the Treasurer's surprise Budget announcement on 12 May 2009.

Section 83A-340

These provisions have retroactive application from 1 July 2009. In some cases, there may be an element of retrospectivity of application of the provisions, but only to backdate the *time* of acquisition of the right, not to effect a retrospective application of the new taxing provisions as some commentators have (incorrectly) stated.

This retrospective application can occur, under the provisions of s 83A-340(1) of the ITAA 1997, where an employee:

- (a) acquires a beneficial interest in a right; and
- (b) the right is later crystallised into a right to acquire a beneficial interest in a share; and
- (c) where (a) and (b) occur, s 83A-340(2) will deem Div 83A to apply, as if the right to the share 'had always existed'.

However, where the original 'indeterminate' right is acquired prior to 1 July 2009, the provisions of Div 83A-5 apply to effectively deem the provisions of Div 13A to apply to the acquisition of the right - which has now morphed into a right to a share.

Interestingly, these provisions of s 83A-340 were a late inclusion in the Bills.

Shortfall Interest Charge

The Shortfall Interest Charge (SIC) may also apply to the amended assessments made in relation to the 2004-05 income year or later years (refer s 280-100(1) of Sch 1 of the *Taxation Administration Act 1953*). The SIC will be 4 percentage points less per annum than the General Interest Charge (GIC).

Under s 280-160 of the TAA, the Commissioner has the power to remit the SIC where he considers it 'fair and reasonable to do so'.

In Practice Statement PS LA 2007/11, where the Government changes the law with retrospective effect, the Commissioner states that if the taxpayer exercises reasonable care and follows the existing law, the SIC (and, if applicable, the GIC and penalties) will not be imposed up to the date of enactment of the legislative change (ie the time of Royal Assent being granted to the Act, which in this case was 14 December 2009), or within a reasonable time thereafter.

Division 13A

If the original 'indeterminate' rights were acquired prior to 1 July 2009, the assessment of an amount to the employee under Div 13A will depend on the conditions attaching to those rights at the time of acquisition. For example:

- whether the rights were provided to employees at a discount to their market values;
- if the rights were qualifying rights, issued at a discount and exercised into shares that were subject to restrictions on disposal and/or subject to forfeiture, the taxing point would be deferred to the earliest of the occasion of:
 - exercise of the rights into fully vested shares (ie no reduction or forfeiture conditions);
 - termination of employment; or
 - cessation of restrictions and/or forfeiture conditions; or
 - the expiration of 10 years.
- had the employee lodged a s 139E election to be taxed (ie) upfront;
- if these rights are non-qualifying rights (eg the rights are in respect of non-ordinary shares or non-employer shares), the plans will be taxed upfront without the need for the employee to make a s 139E election;
- whether the \$1,000 per annum tax exemption provisions apply;
- whether the Commissioner will permit the employee to lodge a late election under s 139E(2A), to be taxed upfront on the tabulated valuation percentages of ss 139FJ to FN of the ITAA 1936:

- whether the rights meet the qualifying provisions of s 139CD (ie rights to ordinary shares of the employer, no participant entitled to more than 5% of the shares, etc).

Division 83A

If the 'indeterminate' rights were acquired on or after 1 July 2009, the assessment of an amount under Div 83A will also depend on the conditions attaching to those rights at the time of acquisition. For example:

- whether the rights were provided at a discount to their market values;
- if the rights were qualifying rights, issued at a discount, but subject to 'real' risks of forfeiture and 'genuine' (ie absolute) restrictions on disposal, the taxing point would be deferred to the earliest occasion of:
 - the vesting of the rights or shares (ie no longer subject to 'real' risks of forfeiture and 'genuine' restrictions on disposal);
 - termination of employment; or
 - the expiration of 7 years;
- the tax-deferred salary sacrifice benefits will be capped at \$5,000 per annum and tax deferred provided there is no risk of forfeiture, but subject to restrictions on disposal;
- the \$1,000 per annum tax exempt benefits will also be available, in addition to the above mentioned deferred benefits, provided the share benefits have no risks of forfeiture, but are subject to a 3-year restriction on disposal, or earlier termination of employment;
- deferral of the taxing point for the employees will likely depend on the existence of a 'real' risks of forfeiture and ongoing 'genuine' (ie absolute) restrictions on disposal as outlined in s 83A-115.

CGT issues

The Black & Scholes-inspired, tabulated valuation provisions of ss 139FJ to 139FN of Div 13A (ie minus the volatility factor) and now incorporated into Div 83A under Regulations 83A-315.08 and .09, mean that most options issued in respect of employment with a current market value exercise price will have a concessional taxable value when acquired by employees and will establish an initial CGT cost base.

Some employee taxpayers may prefer to pay the concessional income tax upfront on the share option benefit when acquired, under Div 13A or Div 83A. They will then pay CGT on the profits made on the disposal of the shares or rights, thereby accessing the 50% exemption applying to taxable capital gains.

Of course, where options are exercised into shares, the shares, being a different chose in action to the options, need to be retained for a 12-month period to access the 50% discount CGT exemption.

Plans to which s 83A-340 may apply

Plans to which s 83A-340 may apply include:

- certain restricted share plans (eg restricted stock units);
- certain share appreciation rights plans;
- certain performance rights plans; and
- option plans with a share or cash-out facility, at the behest of the employer.

While the appellations 'share appreciation rights', 'performance rights' and 'restricted stock units' can be used loosely, in many of these arrangements, the company does retain the ultimate discretion to use shares or cash in lieu, and the ATO has usually ruled that the provision of these rights has not constituted the acquisition of a 'right' to a share by the employee for the purposes of the Div 13A.

Similarly, where options are issued to employees and the company retains a capacity to have the plans cancelled for a cash amount equal to their value or exercised into shares, the ATO has also similarly ruled that these plans do not constitute a 'right' to a share for the purposes of Div 13A.

Options with a 'cash out' facility are often used for companies not listed on the ASX. The value of the option at the same time of vesting is easily determined as it is simply the difference between the exercise price of the option and the value of the share, at the time of exercise of the option. If the share price has increased over the exercise price during the holding period of the option, the employer will realise a cash benefit upon cancellation of the option. This is a straightforward and effective way of providing an internal market for the options, for employees to realise value from their options.

Examples of indeterminate share rights

The Explanatory Memorandum to the Bill contains a number of examples of indeterminate share rights which are summarised below.

Faiza: Simple example

Faiza will receive rights at a discount to an indeterminate number of employer shares crystallising in 2 years on a one-on-one basis with the number of dishwashers she sells. Faiza must determine whether her tax liability is deferred or pays tax upfront when she originally received the rights.

Miranda: Upfront taxation

Miranda is granted rights at a discount to an indeterminate number of employee shares. She already owns a 6% stake in her employer. Consequently, after 5 years, when her rights become rights to 568 shares, she will be taxable upfront, but backdated 5 years to the date of acquisition of the original rights. Her rights are not qualifying share rights because her shareholding exceeds 5% of the issued shares of the company.

Caitlin Share Appreciation Rights (SARS)

In 2010, Caitlin receives SARS at a discount, subject to a real risk of forfeiture, calculated by reference to the increase in her employer's share prices over 3 years. In 2013, Caitlin receives the shares. She will be taxable on the shares in the 2013 tax year, when the risk of forfeiture ceases.

Peter: Shares or cash

Peter receives a discounted right to receive employer shares or cash, if he remains employed with his employer for 10 years. Peter receives rights to shares after 10 years. He is assessable after 7 years, when his income tax assessment will be amended.

Odon: Shares or cash

Odon receives a right to employer shares or cash in 7 years if the share price increases by 30% or more over that time. After 7 years, Odon receives the shares. Four years after acquiring the indeterminate right, Odon ceases employment.

After 7 years, the share prices have increased by 50% and Odon crystallises the rights to shares.

Odon will be taxable on the value of the shares rights at the end of year 4, as the cessation of his employment triggers the taxing point.

Chikako: Shares or cash

Chikako receives rights to shares or cash in 3 years time, provided she meets certain performance hurdles. She fails to meet those hurdles and receives neither shares nor cash.

Chikako has received *no* taxable benefit in respect of her rights.

Oman: Rights to shares or cash

Oman is granted a right to employee shares or cash in 2 years time, subject to achieving certain performance hurdles.

Oman meets his performance hurdles and the company exercises its discretion to grant the value of the shares in cash. He does not have an ESS interest but will be assessed on receipt of the income paid in lieu of receipt of shares.

Impacts of s 83A-340

As practitioners in this area, we have found the impact of s 83A-340 of the ITAA 1997 to be generally beneficial as they apply a consistent deferral period for all potential share benefits, including 'indeterminate' rights which crystallise into rights to shares at some time in the future.

However, where such indeterminate rights may result in the crystallisation of rights to shares, both employees and employers will need to be aware that these rights will trigger a backdated tax (and possibly SIC) on acquisition, unless:

- the rights were *not* issued at a discount; or
- the rights were issued at a discount ; and
- there are restrictions on disposal (ie) for the \$5,000 per annum salary sacrifice benefits *and* the \$1,000 per annum tax exempt benefits) and the rights are not subject to forfeiture; and/or

- there are further allocations of rights which are subject to both a real risk of forfeiture and genuine restrictions on disposal of the rights.

This will provide more clarity and certainty to advisors, companies and their employees in respect of the various types of plans providing such indeterminate rights, especially where employees have exercised those rights into shares since 1 July 2009.

[*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.*]