



**ASSISTANT  
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NO. 11

## **TAXATION OF EMPLOYEE SHARE SCHEMES**

The Assistant Treasurer, Senator Nick Sherry, today released a Policy Statement setting out the final taxation treatment of shares and rights acquired under employee share schemes, effective from today. The final policy provides further certainty to allow companies to continue to provide share schemes into the future.

“The Government strongly supports employee share schemes. We also support the role of the tax system in encouraging employees to be involved in share schemes – we made that clear in the Budget and we’ve been consistent in that support.”

“As with all tax policies, however, the overall integrity of the tax system is a critical concern. The Government must balance its obligations to ensure ongoing system integrity and the need to be sure that our tax system applies fairly and equitably to all Australians.”

“These are the motivations for the Government’s reforms to the taxation of employee share schemes,” said the Assistant Treasurer.

Under the arrangements outlined on Budget night, all discounts on shares and rights provided under an employee share scheme would be assessed in the income year in which the shares and rights are acquired.

The Government issued a public consultation paper on a new regime, which sought to balance industry concerns with the need to address the acknowledged problems of tax evasion and tax avoidance.

“As part of that consultation process, the Government has taken on board the concerns raised and examined the most efficient way of protecting the tax base and cutting down on potential avoidance and confusion at the higher end while maintaining the current support for employee share ownership schemes, particularly for low and middle income workers.”

“The Government is announcing today that it has adopted the changes that were proposed in the consultation paper with several final modifications to address some of the concerns raised during the consultation,” said the Assistant Treasurer.

Modifications from the position announced in the consultation paper are:

- increasing the income tax threshold for eligibility for the upfront tax concessions from \$150,000 to \$180,000, to align it with the top marginal tax rate threshold;
- providing further clarity on the meaning of “real risk of forfeiture” via the use of explanatory materials and Tax Office materials, including through the use of a range of example cameos to assist industry;

- Employees receiving benefits under these schemes will not be able to pay tax upfront and the scheme’s governing rules must clearly distinguish these schemes from those eligible for the upfront tax exemption.
- moving the deferred taxing point from a point at which the taxpayer will no longer have a real risk of losing the share or right to a point at which:
  - in the case of shares, there is both no longer a real risk of the taxpayer losing the share and no restriction (present at acquisition) preventing the taxpayer from disposing of the share; and
  - in the case of rights to shares (options), there is both no longer a real risk of the taxpayer losing the right and no restriction (present at acquisition) preventing the taxpayer from either disposing or exercising of the right, however, if after exercising the right, the underlying share is subject to forfeiture and restrictions preventing the taxpayer from disposing of the underlying share, it is the point at which there is both no longer a real risk of the taxpayer losing the share and no restriction (present at acquisition) preventing the taxpayer from disposing of the share.
- allowing the deferral of tax in relation to up to \$5,000 worth of shares under particular salary sacrifice based employee share schemes, where there is no real risk of forfeiture.
- removing the reporting requirement for employers to report the market value of employee share scheme benefits in the year of grant, if this is not the year in which the employee is taxed; and
- establishing a three part forward plan of consultation with industry by:
  - asking the Board of Taxation to examine two remaining issues (a) how best to determine the market value of employee share scheme benefits; and, (b) whether shares and rights under an employee share scheme that are provided by start-up, research and development and speculative-type companies should be subject to a tax deferral arrangement, despite not being subject to a real risk of forfeiture;
  - commit to an Exposure Draft process of the Bill to ensure the policy is accurately reflected in the application of the law, including consultation on a range of technical issues raised in submissions that will be contained in the Exposure Draft Bill; and
  - supplementing this process by asking the Board of Taxation to consult with stakeholders ,in particular interested members of the previous Consultative Group, to examine technical matters associated with the implementation of these reforms, and to report to Government in time to allow the Board’s views to be taken into account in the draft legislation.

“This final framework will boost integrity through reporting, better target support through the income threshold applying to the upfront concession, and greatly improve corporate governance outcomes by requiring most schemes to feature a real risk of forfeiture to gain access to the deferral tax concession.”

“Salary sacrifice based schemes will also benefit through a targeted cap that will facilitate limited deferral for most members.”

“I would like to thank industry and the various stakeholders for working with the Government during the last few weeks,” said the Assistant Treasurer.

Under the final framework for employee share schemes, the taxation of discounts on shares and rights acquired under an employee share scheme will remain the starting principle of the regime, with concessional treatment available for particular schemes.

The upfront tax exemption will be means tested and tax deferral will only be accessible where there is a real risk that the shares or rights may be forfeited, such as due to performance hurdles or employment conditions. The pre-Budget use of cessation of employment as a taxing point will be retained and the maximum 10 year deferral period will be reduced to seven years.

A full reporting regime will also be introduced to significantly boost the integrity of the taxation of share schemes.

The combination of these final reforms and the measures out in the 5 June, 2009 consultation paper are set out in the attached Policy Statement.

As previously announced, the existing law will apply to all shares and rights acquired before 1 July 2009. The Government will introduce the legislation during the Spring Sittings of Parliament.

CANBERRA

1 July, 2009

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## POLICY STATEMENT

### **FINAL FRAMEWORK FOR THE TAXATION OF EMPLOYEE SHARE SCHEMES**

Key features of the final framework for the taxation of employee share schemes include the following.

- Tax on the discount for shares and rights acquired under an employee share scheme will be paid upfront except where there is a “real risk of forfeiture” or where it comes from a capped salary sacrifice based scheme, and the scheme satisfies the existing conditions for a qualifying employee share scheme.
  - Explanatory materials and Tax Office materials are being developed to assist taxpayers with applying the principle of real risk of forfeiture to their particular facts and circumstances.
  - Further examples to assist in the interim are contained below.
- A new annual reporting requirement will be introduced for employers offering employee share schemes.
  - In the consultation paper, it was proposed that employers be required to report on the number of shares and rights provided at grant and the market value of those shares and rights both at grant and at the taxing point (if different). To minimise compliance costs, employers will only be required to provide the market value of shares and rights acquired under an employee share scheme at an employee’s taxing point.
- Eligibility for the deferral treatment will flow from the structure of the scheme rather than from a choice made by an employee.
- The deferral arrangements applying to a capped salary sacrifice based schemes will be limited to \$5,000 worth of shares.
- The maximum time for deferral of tax is reduced from ten years to seven years.
- The upfront tax exemption will be means tested. The \$1,000 tax exemption will only be available to taxpayers with an adjusted taxable income of less than \$180,000.
- In order to simplify the existing arrangements, the new rules will be rewritten into the *Income Tax Assessment Act 1997*.
- The Board of Taxation will be asked to consider:
  - how best to determine the market value of employee share scheme benefits; and
  - whether employee share scheme shares and rights that are provided by start-up, research and development and speculative-type companies should be subject to a tax deferral arrangement, despite not being subject to a real risk of forfeiture.

The Government will announce the terms of reference for the Board of Taxation reviews shortly.

## **THE REAL RISK OF FORFEITURE TEST**

- The “real risk of forfeiture” test, as foreshadowed in the consultation paper does not require employers to provide schemes in which their employee share scheme benefits are at grave risk of being lost.
- Rather, it is intended to target schemes which contrive to defer tax without complying with the intent of the proposed law, and to provide for deferral of tax when there is a real incentive to the employee through having their benefits at risk.
  - This is consistent with the policy rationale for the concessional tax treatment of employee share scheme arrangements.
- The test of “real risk of forfeiture” is whether a *reasonable person* would conclude that there is a real risk that the share or right will not come home to an employee by a particular time and be forfeited. The consultation paper notes that:
  - the risk must be a real risk – contrived schemes, where the risk is highly unlikely to arise, will not qualify (for example, ‘your shares are forfeited if the company’s value falls by 95 per cent during the next 12 months’ and ‘your shares are forfeited if you request they be forfeited’).
  - a real risk includes situations in which a share or right is subject to meaningful performance hurdles or the securities will be forfeited if a minimum term of employment is not completed. However, a condition that merely restricts an employee from disposing of a share or right for a specified time carries with it no real risk of forfeiture.
- Explanatory materials and Tax Office materials are being developed to assist taxpayers with applying the principle of real risk of forfeiture to their particular facts and circumstances.
  - These will be developed in consultation with interested parties as part of a further round of consultation on the legislation.
- Whilst the presence of a real risk of forfeiture will serve as an access point to the deferred tax concession arrangements, the removal of such a real risk forms part of one of the three taxing points (in combination with the ability to trade in the shares over which the real risk has been removed).
- Further examples to assist in the interim are contained below.

### **Examples**

#### **Forfeiture on cessation of employment**

Matt enters an ESS arrangement with his employer, XYZ. He will receive 1,000 XYZ shares in three years, if he is still employed by XYZ at that time.

*Real risk of forfeiture:* Yes, Matt’s shares are at risk and he will defer tax for three years, or until he ceases employment with XYZ.

### **Forfeiture on cessation of employment – a different test**

Suzy enters into an ESS arrangement with her employer, AAA. She will receive 1,000 AAA shares in three years, if she is still employed by AAA at that time.

Further, Firm AAA will grant her shares if she ceases employment before three years for an unexpected reason, such as sickness, invalidity or to raise children under a 'good leaver clause'.

*Real risk of forfeiture:* Yes, Suzy's shares are at risk and she will defer tax for three years or until she ceases employment. However, if most employees at Firm AAA received their shares regardless of their reason for leaving, the Tax Office may consider whether the scheme has contrived a 'real risk', and is not eligible for deferral of tax.

### **Fraud or gross misconduct**

Joe enters into an ESS arrangement with his employer, SAS. He will receive 1,000 SAS shares in three years, unless he is dismissed for fraud or gross misconduct.

*Real risk of forfeiture:* No, Joe's shares are not at any real risk. A reasonable person would not consider there to be a real risk of forfeiture in relation to the scheme.

### **Performance hurdles**

Amy enters into an ESS arrangement with her employer, PPP. She will receive 1,000 PPP shares in one year, if PPP's market share has increased in 12 months time.

*Real risk of forfeiture:* Yes, Amy's shares are at risk and she will defer tax for the year.

### **Performance hurdles over a portion of ESS benefits**

Brad enters into an ESS arrangement with his employer, GRR. He will receive 1,000 GRR shares in one year if GRR's market share increases over the year, and 500 GRR shares in one year if it does not.

*Real risk of forfeiture:* Yes, but only in respect of 500 shares. 500 of Brad's shares are at risk and he will defer tax on these for the year. However, Brad's other 500 shares are not at risk, and he will pay tax upfront on these.

### **Performance hurdles that have been met**

Gillian enters into an ESS arrangement with her employer, ASD. She will receive 1,000 ASD shares in two years if she makes \$50,000 worth of sales in those two years. At the point of entering the arrangement, her shares are at risk for two years.

*Real risk of forfeiture:* Yes, but only in respect of the performance hurdle. Gillian makes \$50,000 in the first six months. At that point, her shares are now no longer at risk, because she performs extraordinarily well and will definitely meet her performance hurdle. She will pay tax in two years time as this is the point at which both the forfeiture conditions and the timing restrictions cease.

## FURTHER DETAILS OF AMENDMENTS FROM CONSULTATION PAPER MEASURES

Changes from the approach outlined in the consultation paper are noted below.

### **Income test for the \$1,000 tax exemption**

#### **Final position**

The \$1,000 tax exemption will be income tested.

The income threshold will be set at an adjusted taxable income of \$180,000.

The Government has increased the threshold from \$150,000 to \$180,000.

### **Deferring the taxing point**

#### **Final position**

The general approach continues as announced in the Budget (i.e., tax on the discount upfront).

Limited deferral arrangements will be reintroduced.

Deferral will be limited to either:

- schemes which require that any shares or rights obtained under the scheme be subject to a real risk of forfeiture; and
- salary sacrifice based employee share schemes offering no more than \$5,000 worth of shares to an employee and where:
  - there is no real risk of forfeiture; and
  - the scheme's governing rules clearly distinguish these schemes from those eligible for the upfront tax exemption.

These schemes will also need to meet the qualifying conditions for deferral under the existing law.

Deferral treatment will flow from the structure of the scheme rather than an election by the taxpayer.

The deferred taxing point will occur at the earliest of:

- in the case of shares, there is both no longer a real risk of the taxpayer losing the share and no restriction (present at acquisition) preventing the taxpayer from disposing of the share; and
- in the case of rights to shares (options), there is both no longer a real risk of the taxpayer losing the right and no restriction (present at acquisition) preventing the taxpayer from either disposing or exercising of the right,
  - however, if after exercising the right the underlying share is subject to forfeiture

and restrictions preventing the taxpayer from disposing of the underlying share, it is the point at which there is both no longer a real risk of the taxpayer losing the share and no restriction (present at acquisition) preventing the taxpayer from disposing of the share;

- cessation of employment; or
- 7 years.

The Government has delayed the taxing point to a position that more closely aligns with the taxing points under the existing law.

The Board of Taxation will be asked to consider whether start-up, research and development and speculative-type companies should be provided with additional deferral arrangements.

Where shares or rights vest after an employee ceases employment with a company, it is open for a company to offer a “partial vesting” arrangement to enable their employees to dispose of a proportion of shares or rights to pay tax crystallised on cessation of employment.

On the broader issue of the use of equity-based payments for executives, the Government has asked the Productivity Commission to examine this issue, in coordination with both the Australian Prudential and Regulation Authority and the Australia's Future Tax System review as part of a broader review of executive remuneration practices.

## Reporting requirements for employers

### Final position

A new annual reporting requirement will be introduced for employers offering employee share schemes.

To minimise compliance costs, employers will only be required to estimate the market value of shares and rights acquired under an employee share scheme at an employee's taxing point. However, employers will still need to report the number of shares and rights an employee has obtained at both grant and at the taxing point.

## Withholding arrangements

### Final position

A limited form of withholding will be introduced in cases where an employee fails to provide their employer with a TFN or ABN.

## Valuation issues

### Final position

That the general principles of market value will apply in determining the market value of listed and unlisted securities.

Regulations will be made to provide for a 'rule-of-thumb' where necessary. As an interim measure the existing valuation rules for unlisted rights will be replicated in the regulations.

The Board of Taxation will be asked to review the existing valuation rules.

## Need for Tax Office approval for employee share schemes to qualify for tax concessions

### Final position

Employee share schemes will not have to be approved by the Tax Office or Australian Prudential Regulation Authority to qualify for concessional tax treatment.

## Refund of income tax for forfeited benefits

### Final position

The refund rules will be extended to cover forfeited shares.

The refund rules will not apply if the extinguishment, forfeiture or inability to vest occurs as the result of a choice the taxpayer makes (including choosing not to exercise a right). Appropriate rules will be put in place to prevent contrived situations.

The Government will fine tune the refund provisions proposed in the consultation paper to ensure that a refund of tax is denied only where the decision to forfeit is related more directly to the loss in the market value of the securities.

## Need for specific anti-avoidance rules/additional penalties

### Final position

No new specific anti-avoidance rules or penalties will be introduced at this time.

**Commencement time for the changes****Final position**

The new arrangements will apply to shares or rights acquired on or after 1 July 2009.

The existing law apply to all shares and rights acquired before 1 July 2009.