

Sydney

Level 29, 66 Goulburn Street
Sydney NSW 2000
T (61 2) 8263 4000
F (61 2) 8263 4111
E info@williambucknsw.com.au

Melbourne

Level 1, 465 Auburn Road
Hawthorn East Vic 3123
Ph: (03) 9824 8555
Fax: (03) 9824 8580
E info@webbgroup.com.au

Adelaide

Level 6, 211 Victoria Square
Adelaide SA 5000
T (61 8) 8409 4333
F (61 8) 8409 4499
E info@williambucksa.com.au

Brisbane

T 1300 787 100

Perth

Level 3, South Shore Centre
83 South Perth Esplanade
South Perth WA 6151
T (61 8) 6436 2888
F (61 8) 6436 2889
E info@williambuckwa.com.au

W www.williambuck.com.au

Changes to the Employee Share Scheme Rules

The 2009/10 financial year looks set to be a year of significant change and uncertainty for employee share plans.

In the May 2009 Budget, the Federal Government announced that from 1 July 2009, all discounts received under employee share schemes would be taxable up-front. This was to apply regardless of whether the employee was able to deal with the shares or was liable to forfeit the shares in some circumstances.

Due to heavy lobbying by industry and professional groups, the Government has substantially backed down from this proposal. Draft legislation has since been released for public consultation. The first tranche of legislation is expected to be introduced to Parliament late in 2009.

Moreover, a range of technical issues has also been referred to the Board of Taxation with their final report due in February 2010. Further legislation is expected to be introduced to Parliament in 2010.

With the government putting such a strong focus on the taxation of employee schemes we recommend that employers review their employee share plan **now** to understand how the tax changes are likely to affect their employees and business.

Although the detail of the changes will take some time to be finalised, we have a good understanding of the core principles that the Government is seeking to apply in its changes.

It is likely that most employee share plans will need to be reviewed, and to a degree, re-designed, due to the proposed changes to the tax laws. At a minimum, the explanation of the tax aspects of the employee share plan in any materials provided to employees will need to be rewritten.

What Are The Key Changes?

Election to be taxed up front (s.139E) abolished

Under the previous legislation, where an employee received qualifying shares or qualifying rights, taxation of the shares or rights was deferred. The employee then had the ability to make a s.139E election to be taxed upfront. Amongst other things, this mechanism enabled employees to maximise their access to the 50% Capital Gains Tax (CGT) discount.

Under the proposed legislation the ability to make an s.139E election will be removed. For shares and rights acquired from 1 July 2009, the employee will not be eligible to choose how the tax rules would apply as they was the case under the previous rules. Instead, the taxing point will be determined by the structure of the employee share scheme – the designer of the plan will effectively dictate how the employees will be taxed.

The base position is that any discounts received under an employee share scheme will be taxed up-front unless certain conditions are satisfied.

Pre- Conditions for Deferral of Taxation

The specific pre-conditions that a plan needs to meet in order for the taxing point to be deferred are similar in most respects to the conditions that previously applied for a plan to be deemed a qualifying plan (and hence open up the ability to make an s.139E election).

The proposed changes in legislation will, however, result in additional conditions that must be met in order to defer taxation.

One of the conditions that must be satisfied is that there must be a real risk that the shares or rights may be forfeited.

The Explanatory Memorandum to the draft legislation states that there is a real risk of forfeiture if:

a reasonable person would consider that there is a real risk that the employee would lose the interest, or never receive it, other than by selling or exercising it or through the market value of the interest falling to nil.

The difficulty with this requirement is the breadth of the potential interpretation. The “reasonable person” requirement makes this an objective test; however the idea of a “real risk” is in itself a subjective concept. This is one of the key areas upon which we are seeking clarification in our submissions to Treasury.

Deferral Point Changed

Under the previous legislation, the taxing point for employee shares or rights could be deferred until the earlier of:

- Disposal of the share or right;
- When any disposal restrictions or forfeiture conditions cease to apply;
- Cessation of employment;
- 10 years from grant of the share or right.

Under the proposed legislation, the taxing point for plans which meet the specific pre-conditions will be deferred until the earlier of:

- When there is no longer any real risk that the employee may forfeit the share or right;
- When the scheme no longer restricts the employee from disposing of the share or right;
- When the employment ends; and
- 7 years from when the employee acquired the share or right.

The key change is a move from a situation where any forfeiture conditions were sufficient to achieve a deferral of tax, to a situation where there must be a “real risk” of forfeiture. The intent is clear – the forfeiture conditions need to be more than nominal. What constitutes a “real risk”, however, is far from clear at this stage.

Ability to Amend Tax Returns Reduced

Under the previous legislation, where an employee was taxed up-front on a discount and those shares or rights were forfeited at a later period of time or the rights were not exercised, the employee had an indefinite period of time to amend their tax return.

Under the proposed legislation, the ability to amend will not be available where the interest has been forfeited because the value of the interest has diminished (for instance if shares drop in value).

If, for example, the market value of a share drops below the exercise price of the employee share options, and as a consequence the employee chooses not to exercise the options, they will not be able to get a refund of tax paid up-front on the options.

Again the intent is clear – the tax system should not underwrite risk on an investment decision. However the special situations applying to many employee share schemes – in particular private companies, start ups and Research & Development focused companies – means the application of the principle is not as simple the proposed legislation implies. This issue was highlighted in submissions to Treasury and is an issue that the Government has requested the Board of Taxation consider.

Tax File Number (TFN) Reporting Implemented

The final key change is the implementation of a TFN reporting system. This change most directly addresses the Government’s concerns over tax avoidance in the employee share scheme space.

All employers who operate an employee share scheme will be required to report annually to the ATO on shares and options issued to employees. Further, where a participating employee does not quote a valid TFN, the employer will have a withholding obligation.

The mechanics of the system are still being developed. In the interim, we are recommending that only employees who can quote a valid TFN be permitted to participate in an employee share scheme.

Next Steps

Employee share schemes continue to represent a valuable and useful remuneration strategy for employers. However, the proposed changes and the current uncertainty mean that additional care needs to be taken to ensure that the tax outcomes of an employee share plan are understood, and are appropriate.

If you need assistance in understanding how your employee share plan will be affected by these changes, please contact your local William Buck office.

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