

The Treasury confuses schemes with scams

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Insurance

(Unwanted) reform of employee share schemes

Since the Federal budget was announced it seems that not a day has passed when the financial press has not carried a story about the Federal Government's unpopular proposal to reform the taxation of employee share schemes. In a rare display of unity, business and unions have joined in attacking the proposed reforms. In response to the chorus of criticism, a few days ago the Treasury released a consultation paper and draft legislation on the tax treatment of employee share schemes. As it is proposed that the new arrangements will commence on 1 July 2009, it is timely to review the current state of play and the Federal Government's revised proposals.

Why reform?

Since March 1995 qualifying employee share schemes have been taxed on a concessional basis under Division 13A of Part III of the *Income Tax Assessment Act 1936 (Cth)*. Under the concessions, employees who receive qualifying securities (e.g. shares, options or rights) at a discount to their market value can either:

- defer taxation of the discount for up to 10 years; or
- elect to be taxed on the discount in the year they receive the shares or rights, but qualify for an exemption for the first \$1,000 of the discount.

Under the budget proposals, the Federal Government planned to limit the \$1,000 tax exemption to employees earning \$60,000 per annum or less, and to remove the opportunity to defer taxation. According to the Assistant Treasurer, the budget arrangements were designed to deal with the current tax arrangements applying to employee share schemes, which involve "excessive concessionality and provide scope for losses to Commonwealth revenue through avoidance or confusion as to the taxpayer's obligations".¹

The government's proposals are intended to apply to shares or rights acquired under an employee share scheme on or after 1 July 2009. The existing law will apply to all shares or rights acquired before this date.

What is proposed?

As a result of considerable public opposition to the measures announced in the budget, the Federal Government proposes to modify its proposals to:

- raise the income threshold for the \$1,000 tax exemption to \$150,000 per annum;

In brief

- Federal Government has modified proposed reforms to taxation of employee share schemes.
- Important changes are still proposed and need to be carefully considered by companies with such shares.

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- introduce a limited deferral of the taxing point for schemes where there is an "genuine risk of forfeiture" of participating shares or rights;
- introduce an annual reporting requirement and associated withholding arrangements;
- review the existing rules for valuing discounted and deferred shares and rights; and
- modify the rules relating to the refund of income tax for forfeited benefits.²

The \$1,000 tax exemption

The Federal Government proposes to increase the income threshold to receive the exemption from the first \$1,000 of the discount from the \$60,000 per annum announced in the budget to \$150,000. The Government expects that the new threshold should cover the vast majority of employees who currently participate in schemes designed around the \$1,000 tax exemption. Companies who have employee share schemes might, however, not agree, especially larger companies who have a broad range of employees participating in such schemes. They are faced with the likelihood of having to restructure existing schemes so as to deal with the new threshold, if it is implemented.

Deferring the taxing point

The Government remains of the view that the taxation of employee share schemes should be on the same basis as other employee compensation, and so income should be taxed in the year that it is earned.

The Government is, however, prepared to recognise that deferral may be appropriate where there is a real risk that employees will not acquire full ownership of shares or rights, or the benefits attaching to them, because those shares or rights are forfeited under the terms of the scheme.³ To this end the draft legislation provides that there must be a real risk under the conditions of the employee share scheme that the employee will never be able to control the circumstances in which the share or right will be disposed of. Examples of a real risk of forfeiture referred to in the consultation paper include a requirement that a participant satisfy meaningful performance hurdles or serve a minimum term of employment.

Reporting requirements for employers

In order to reduce current levels of both intentional and unintentional non-compliance with the taxation requirements applying to share schemes, the Government proposes to introduce reporting requirements for employers who offer employee share schemes. The requirements will apply to all employee share schemes, not just those that qualify for concessional tax treatment.

The Government is proposing that employers must provide the Australian Taxation Office with a statement each financial year that covers each participating employee in a

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share scheme. Each statement will be required to include the following information:

- details of the employee and the number of shares and rights acquired by the employee under the share scheme in the financial year;
- the employer's estimate of the total market value of those shares and rights when the employee acquired them;
- the number of shares and rights that were, in the relevant financial year, subject to a deferred taxing point and the employer's estimate of the total market value of those shares and rights when they were subject to a deferred taxing point; and
- the total amount contributed by the employee towards the acquisition of the relevant shares or rights.

An employer will also be required to provide each affected employee with a similar statement.

Determining the size of the taxable discount

Under the current law, a participant in an employee share scheme is liable to tax (subject to the tax exemption and deferral rules) on the difference between the market value of the securities issued to the employee and the amount paid by the employee – i.e., the employee is taxed on the discount from the market value of the securities. In the case of listed securities, the market value can be readily determined. However, determining the market value for unlisted securities is more complex. Currently there is no definition of market value in any general provision of the current tax law.

The Government is concerned that the approach taken to determining the market value of securities is presently resulting in undervaluations and therefore a loss of tax revenue.

Given the complexities of determining market value, the Government is presently of the view that it is not appropriate to prescribe the basis upon which market value should be determined and, for the moment, will by and large retain the current approach. However, the Government proposes to review the valuation rules thoroughly and consider whether they should be retained or modified.⁴

Refund of income tax for forfeited benefits

The Government proposes that if shares or rights do not vest or are forfeited, then any tax that has been paid on acquisition will be refunded, unless the extinguishment or forfeiture occurs as a result of a choice the employee

makes, including, for example, choosing not to exercise an option because the value of the underlying shares has dropped. This should remove an inequity that would otherwise have arisen under the budget measures, which could have resulted in taxation for employees whose shares were forfeited as a result of rules that, in certain circumstances, deem an employee to have realised a capital gain on forfeited shares.

What should you do now?

The financial press has reported that a number of companies have suspended the operation of their employee share schemes in light of the budget measures.

The government now proposes to introduce the new measures contemplated by the consultation paper from 1 July 2009.

Companies should be carefully reviewing the structure of their current employee share schemes to determine how the new measures will affect them and how they might be restructured, for example, to deal with the new threshold for the \$1,000 tax exemption.

For listed companies caution must be exercised however as many employee share schemes have been structured to take advantage of the exemption in Listing Rule 7.2 from the requirement that a company must not issue more than 15% of its issued capital in any 12 month period, except with shareholder approval. The employee share scheme exemption will not apply however where there has been a change to any of the material terms of the scheme.

In considering amendments to the terms of incentive schemes that involve the issue of options, listed companies also need to be aware of the restrictions in the listing rules on amending the terms of options, including the prohibition of reducing exercise prices.

If a restructure of existing schemes is undesirable, companies might need to consider alternatives, such as so called phantom share plans in which the employee receives a cash bonus based on share performance or plans under which the company finances any up front tax payment by the employee. These alternatives have their own advantages and disadvantages, and would need to be carefully considered before implementation.

- ¹ Media release of 05/06/2009, no. 061, by the Assistant Treasurer and the Treasurer.
- ² Reform of the taxation of employee share schemes, consultation paper, June 2009, page 5.
- ³ Consultation paper, page 16, paragraph 58.
- ⁴ Consultation paper, page 25, paragraphs 99 to 102.

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