

Global Rewards Update: Australia – New Employee Share Scheme draft tax rules released

January 2015

Background

Further to our Global Rewards Update of **October 2014**, the Australian government has released drafts of the amendments to the employee share scheme (ESS) tax rules. The changes are proposed to take effect for ESS interests, such as shares (i.e. restricted shares) and rights to shares (i.e. share options), acquired (i.e. granted) on or after 1 July 2015.

The draft amendments propose to:

- reverse some of the changes made in 2009 to the income tax point for ESS rights for employees of all corporate tax entities;
- introduce a tax concession for employees of certain small start-up companies; and
- authorise the Australian Taxation Office to work with industry to develop safe harbour valuation methods, supported by standardised documents. The aim of this is to streamline the establishment and maintenance of ESS to improve the tax treatment of ESS and stimulate the growth of innovative start-ups in Australia.

Reversing and improving certain parts of the 2009 reforms

Relaxing the significant ownership and voting rights limitations

Under existing rules, in order for rights to be taxed at the deferred taxing point rather than at acquisition, certain conditions need to be met.

One of these conditions under existing rules requires that immediately after the acquisition of the rights, the participant does not have ownership or voting rights of more than 5% in the company. Under the drafts of the amendments, the limitation will increase from 5% to 10%.

However in determining this percentage, the employee will need to take into account the shares that they could obtain by exercising their rights.

Employee share scheme deferred taxing points for rights

Under existing rules, awards that qualify to be taxed at the ESS deferred taxing point are generally taxed at the earliest of:

- a) cessation of employment;
- b) if the shares have a real risk of forfeiture and genuine disposal restrictions, the time when these forfeiture/disposal provisions expire;
- c) if the rights have a real risk of forfeiture and genuine disposal restrictions, and there are forfeiture or disposal restrictions on the underlying shares, the time that the forfeiture/disposal restrictions expire on the shares;
- d) if the rights have a real risk of forfeiture and genuine disposal restrictions, and there are no forfeiture or disposal restrictions on the underlying shares, the time of **vesting** of the rights; and

- e) **seven** years from the date of acquisition.

The amendments propose the following changes to d) and e) above:

- d) **exercise.**
- e) **fifteen** years from the date of acquisition.

Changes to the refund of income tax for forfeited shares and rights

While termination of group employment remains a potential taxing point, the refund provisions will be extended. They will now allow for a refund of income tax paid in certain circumstances where an employee chooses not to exercise a right, including, relevantly, where the employee does not exercise an underwater option after termination of employment.

No refund of income tax, however, will be permitted where the ESS was structured to directly protect the employee from downside market risk.

Updated market value valuation table

The existing ESS tax valuation tables for unlisted rights in the regulations will be updated to reflect current market conditions. Generally, the updated market value valuation table will produce a lower taxable market value per right than the existing tables.

Concessions for interests in small start-up companies

A start-up company broadly means an Australian tax resident employer that offers for acquisition ESS interests in an unlisted company with an aggregated turnover not exceeding A\$50 million, with all companies in the corporate group having been incorporated for less than 10 years.

To be eligible for the start-up concession, certain conditions must be met, including:

- *ESS shares* must have a discount of less than 15% of the share market value at time of acquisition;
- *ESS rights* must have an exercise price that is greater than or equal to the ordinary share market value at time the right is acquired (i.e. market value or premium options);
- the rights or shares must be held for a period of 3 years or until termination of employment with the employer or group company, if earlier.

Where a start-up company's ESS and the employer meet the start-up concession conditions, the employee will not be subject to income tax on the ESS interest discount. Rather, the employee will be subject to capital gains tax rules on any gain above:

- the market value of the *share* at acquisition (i.e. the 'discount' becomes effectively tax-free as the capital gains tax cost base includes the full market value of the shares); or
- the cost of acquisition of the *right* (i.e. there would be no taxation at exercise).

Note that as a consequence of the start-up concession, capital gains tax exemptions for temporary residents have been modified so that such exemptions do not apply to start-up ESS.

Deloitte view

In our submission to the government in February 2014, we called for a broader change to the tax on employee options as well specific equity tax incentives for start-ups. We are pleased to see that the vast majority of our suggested changes have been included in the draft, or called for in the further consultation.

There are, however, still unanswered questions and important areas to consider. For example:

- What is the broad interpretation of "exercise" for rights other than share options (i.e. are restricted share units that automatically 'exercise' taxed when real risk of forfeiture ceases or are they taxable when shares are received)?
- Under the new '10%' ownership rule, are rights included only if they have vested and can be exercised or are all rights included in the 10% calculation?
- How should market value of unlisted rights be determined beyond 10 years (as the proposed new valuation table is limited to 10 years)?

- If there is an aggregate turnover threshold and an incorporate maximum period of 10 years to access the start-up concession, is it relevant if a company is listed or not?
- Aggregated turnover includes affiliates and connected organisation, so special care need to be taken when assessing the A\$50 million threshold.
- The drafting of the rules affecting ESS rights for start-ups appears to rule out providing a full value share in the future (i.e. an RSU type award) and is limited to share options. As rights to full value shares are a more common type of equity plan globally, this should be reconsidered.
- The amendments suggest that the governing rules of the scheme must expressly state the relevant provisions to apply for the deferred taxing point. Does this mean that when an individual comes to Australia holding an overseas ‘right’, they may not qualify for some of the broader changes unless the plan or the offer document of the award specifically states the provisions?
- Currently there are boxes on the ESS reporting document for pre and post 1 July 2009 income. Confirmation is required on whether a third box to report post 1 July 2015 income will be available. In addition, what reporting will employers need to comply with for the ESS start-up plans?

Action

Deloitte will continue to work with the government on these proposed changes. If your company would like to be part of the Deloitte representations to government, then please join the debate on our website <http://www.retainingtalent.com.au/> before the submission closing date of 6 February 2015.

People to contact

For assistance with these issues, or any other issue related to the operation of your global equity plans, please contact your local Deloitte adviser or email us at globalshareplans@deloitte.co.uk, and an adviser will contact you.

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