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Improvements to taxation of Employee Share Schemes

Executive Summary

On Wednesday 14 January, 2015, the Government released an Exposure Draft Bill on its promised changes to the Employee Share Schemes (ESS) rules. These changes will help realign the Australian tax treatment of ESS, in particular share options, with international best practice.

The key reforms in the Exposure Draft include:

- rights to acquire shares (including share options) will become taxable at exercise
- the opportunity to defer taxation of ESS rights, that are not subject to a real risk of forfeiture, but only a restriction on disposal
- the maximum period for deferral of tax will increase from 7 to 15 years
- Employees with ownership and voting rights up to 10% (increased from the current limit of 5%) will be eligible for deferral of taxation on ESS grants
- reductions in the valuations under the safe harbour valuation tables and new market valuation methodologies
- increased opportunity for employees to claim an income tax refund on rights that have been taxed at an earlier point and subsequently lapse
- new tax concessions for qualifying Australian start-ups.

Many of the above changes will positively impact all companies. However, as far as most companies are concerned, the two significant changes are to the taxation of ESS rights (i.e. performance rights and options), being:

- the deferral of taxation of rights to exercise rather than earlier, as at present; and
- the deferral of tax even where an ESS rights scheme does not include a “real risk of forfeiture”.

These changes can significantly improve the alignment of executive remuneration with shareholder interests and provide Boards with increased flexibility to structure remuneration to suit the company’s circumstances.

We discuss each of these changes in more detail below.

What changes are in store?

The proposed rules will apply to employee shares, options and rights granted on or after 1 July, 2015.

Taxation of “rights” at exercise

Yes, that includes options – an option being a ‘right to acquire a share’ for an exercise price.

Perhaps the most anticipated change in the Exposure Draft is that rights to acquire shares (including share options) will be taxable at exercise. The Explanatory Memorandum clearly states the intention is to change the taxing point for ESS rights so that it is the date when the right ***is*** exercised, and ***not***, as at present, the date at which the right ***can*** be exercised. However, the Exposure Draft wording needs to be clarified to ensure this intention is achieved.

Treasury has confirmed the stated intention to tax at exercise and has undertaken to ensure the Explanatory Memorandum provides clearer guidance.

As many will agree, the 2009 changes effectively made share options an impractical and ineffective means to remunerate Australian employees. Under the current rules, employees must pay tax when they are no longer subject to forfeiture. This is the case even if they never exercise the options. As a result, multinational companies were reluctant to operate their global plans in Australia given the potential for an adverse tax outcome for employees. Additionally, start-up companies were limited in their compensation strategies to attract talent.

The change proposed in the Exposure Draft will make options an attractive form of rewarding employees, as the taxing point will align with the time the employee is able to realise a gain on the options.

Similarly, the taxing point for Performance Rights will generally be the time they are converted into shares rather than the earlier time when there is no longer a risk of forfeiture.

The new rules will ensure the Australian tax treatment is more closely aligned with international practice, assisting the operation of multinational companies operating in Australia.

Share options will not, of course, be appropriate for all companies. However, the changes will enable companies to consider remuneration structures that are tailored to the company's particular circumstances.

Action point: companies should consider the pros and cons of deferring the grant of Performance Rights and/or options until 1 July 2015 or later if they would otherwise be granting before that date.

New opportunities under Deferral Schemes

One of the more important changes in the Exposure Draft relaxes the requirement for companies to include a real risk of forfeiture within an ESS rights plan to achieve tax deferral. Rather, the Exposure Draft includes scope to allow for deferral of tax on ESS rights provided the rights are subject to a restriction on disposal. For qualifying schemes, the taxation of the ESS rights can be deferred until the disposal restriction (on the rights and underlying shares) is lifted.

This will effectively extend the deferred tax treatment for companies that can see the benefits of structuring rights and option plans that do not include a risk of forfeiture but simply a genuine restriction on sale of the rights/options and underlying shares.

By extending the deferred taxation treatment, this change (reflecting in part the pre-2009 rules) allows companies to implement ESS that are less concerned with the risk of forfeiture, and more focused on creating plans that align employee compensation with shareholder returns. The employee's equity remuneration will move in line with the share price.

Action point: companies should consider the opportunity to review the remuneration framework to determine the extent to which a deferral structure without a forfeiture risk can provide better outcomes for employees and shareholders.

Safe harbour valuations

The safe harbour valuation tables have also been revised to reflect current market conditions and, as a result, generally reflect lower values than the existing tables.

These tables can be used to calculate the market value at the taxing point whether that be at grant or on termination of employment.

Additionally, the Commissioner of Taxation will have discretion to approve other safe harbour valuation methodologies, as appropriate. Once approved, these methodologies will be binding on the Commissioner. This discretion will enable companies to use a methodology that is suitable for their particular circumstances and is most relevant for private companies that currently have difficulties with the valuation rules.

These changes will help improve certainty, as companies have confidence in the methodologies they have applied. The changes should reduce the compliance costs of maintaining an ESS.

Action point: if your ESS arrangements have relied on the table valuations, it may be appropriate to defer any grants to 1 July 2015 or later.

Action point for private companies: if the valuation methodology has been an issue in implementing a plan, there can be an opportunity to revisit.

Income tax refunds

The proposed changes allow for a refund of income tax when an employee is taxed on their rights to acquire shares (e.g. performance rights or options) and the rights subsequently lapse without being exercised.

The current law does not allow for a refund if, for example, an employee has been taxed at an earlier point and does not exercise their options because the share price is less than the exercise price. In that case, the employee would incur a capital loss.

The proposed change will provide for a refund in these and similar circumstances.

Refunds will not be available to employees where the conditions of the ESS were constructed to protect the employee from market risk.

This provision is an important step to help improve some of the adverse effects created in the 2009 reforms.

It is to be noted that this improved treatment only applies to rights granted on or after 1 July, 2015.

Action point: we encourage companies with examples of inequitable taxing points without refunds after 1 July, 2009, to contact us as we pursue the consultation process with Treasury and the Government.

A fairer outcome may be that this provision should apply to any arrangements that remain on foot rather than those that commence on 1 July, 2015.

Start-up concessions

The Exposure Draft details concessions that should make employee share schemes more attractive for start-up companies.

Subject to certain criteria, the key provisions in the Exposure Draft provide for:

- income tax exemption on discounts of up to 15% on grants of shares; and
- taxation under the capital gains tax (CGT) rules for options that are granted with an exercise price no less than the market value of the share at time of grant.

The concessions are designed to help alleviate the cash flow difficulties that start-ups generally encounter. Such companies have traditionally relied on share options to attract and remunerate the best talent, as they have limited cash to pay competitively while the company focuses on growth.

These concessions are a welcome reform as they will enable start-ups to grant options to attract and retain key talent. Currently, options are ineffective as employees pay income tax when they are no longer subject to forfeiture, and capital gains tax on any share growth once exercised and acquired. However the new concessions will provide a genuine incentive for employees as they will not pay tax until they sell their shares, at which time capital gains tax will apply.

We note that the definition of a start-up is limited and, in particular, excludes any listed company. Many companies in the junior mining and technology sectors have, traditionally, listed early so that they can gain access to the capital markets. However, such companies could rightly be classified as start-ups and would benefit from the concessions outlined in the Exposure Draft.

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