EMPLOYEE SHARE SCHEME RULES OVERHAUL

AS FORESHADOWED IN OUR RECENT ARTICLES (4 AUGUST AND 8 OCTOBER), THE FEDERAL GOVERNMENT HAS NOW COMMITTED TO: (A) REVERSING (AT LEAST IN PART) THE CONTROVERSIAL EMPLOYEE SHARE SCHEMES TAX CHANGES IMPLEMENTED IN 2009 AND (B) SET UP A SEPARATE TAX REGIME FOR START-UP ENTITIES.

As part of its Industry Innovation and Competitiveness Agenda, the Government will reverse the changes to the tax treatment of employee share schemes that were introduced by the former Government in 2009. The changes will also introduce a new tax regime applicable to 'start-up' companies, which is designed to "stimulate growth of high technology companies" and "help small unlisted companies be more competitive in the labour market".

This reform is long overdue and will assist companies (particularly, start-up companies) operating in the Australian market to attract top talent and remain internationally competitive. Unfortunately while it is a step in the right direction, the proposed tax rules do not appear to go far enough in meeting all of the challenges faced under the current tax regime and to compete with other jurisdictions in relation to attracting and retaining talented employees.

The new employee share scheme tax rules are expected to come into effect on 1 July 2015, following consultation between the Treasurer, industry and stakeholders to ensure that the draft legislation delivers the intended outcomes. This reform is estimated to cost around A$200 million in lost tax revenue over four years.

Although the Government intends to roll back some of the pre-2009 rules, it does not appear that there will be a complete reversal of the tax position for employee share schemes. While the specific details have not yet been released, the Government has revealed that the proposed new tax rules will include the following attributes.

REVERSING THE CHANGES MADE IN 2009 TO THE TAXING POINT FOR OPTIONS

Current position

The main issue with the 2009 (and current) tax rules is that to defer tax, the offer to an employee needed to include a 'real risk of forfeiture'. This means that in order not to give an employee an up-front tax bill, their equity interests needed to be 'at risk' of being forfeited, if certain circumstances arose. The most common condition was where the employee left employment pre-vesting and this would mean that they forfeited their interests. As a result, this can make it very hard for employers to incentivise employees where the employee would have the choice between paying tax up-front, or deferring tax, but attributing nominal or nil value to their employee share scheme equity, due to the risk of forfeiture.

Specifically, where an employee remains in their employment, the current deferred taxing point for options is when all of the following things occur:

- the real risk of forfeiture ceases or is released;
- the employee can exercise the option;
- the employee can exercise the options and receive the share, where there is no risk of forfeiture in relation to the share; and

- the employee was, but is not now, restricted from selling or transferring the share.

It should be noted that in some cases under the current tax rules it will be preferable for an employee share scheme to be structured so that options issued under the scheme are taxed up-front, and that the options granted to employees have an exercise price and a term which means that the up-front tax amount is minimal. The advantage of this approach is that while an employee will be required to pay tax up-front (albeit nominal tax), any increase in the underlying share value will be taxed under the capital gains tax regime and may attract the 50% capital gains tax concession where the shares are held for more than 12 months before they are sold. At this stage it seems that the ability to structure option grants in this way will remain.

Proposed changes

Under the proposed changes, employees will generally be taxed at the time options are exercised and shares are received by an employee, rather than where they are taxed either when an employee receives options (if there is no real risk of forfeiture) or more commonly when options vest under the current tax rules. This change will apply **to all companies**.

This should overcome the scenario where a current employee would be taxed when an option vested, even if the option was "out of the money" at that time and even in circumstances where the option may not be exercised and the employee may not actually realise any value in the future. This created an unusually unfair outcome as the employee would be faced with a tax bill in relation to an out of the money option (which they would not exercise in any case).

This announced reform is welcome development, as it will provide some measure of control to an employee as to when options are taxable (when the options are actually exercised) and reduce the risk of an employee being taxed on options received at a time when they have not actually realised any value. Those employees will now potentially be able to fund their tax bill by selling some of the shares they receive on exercise. Clearly a common sense result.

Capital gains tax will remain payable on the sale of those shares, and where the shares are held for more than 12 months and certain other requirements are met, the 50% CGT discount will continue to apply to any capital gain. However, any increase in value between vesting and exercise will now be subject to income tax and not capital gains tax.

It should be noted that the Government is not proposing to reintroduce the ability of employees to elect how they wish to be taxed, either to pay up-front tax or to defer tax. As a result, whether tax is payable up-front or deferred will still be determined by the structure of the employee share scheme and the offer to the employee. It is also not entirely clear from the material released to date whether the requirement for there to be tax deferral of a "real risk of forfeiture", and for there to be a "genuine disposal restriction" for further deferral, will continue to have any role in the taxation of options.

The current potential A$1,000 up-front tax concession for employees who meet the current A$180,000 per year income threshold will also be retained.

Remaining issues

There are some further issues which it is hoped that the Government may also look to address as part of the consultation process:

- the cessation of employment as an earlier taxing point appears set to remain, keeping Australia out of step with most of the developed world. Where an employee ceases employment but continues to hold their options (perhaps because they are a "good leaver"), then they are required to pay tax while not having yet (and maybe never) realised any value. When participating in an employee share scheme, the Government requires an employee to provide their Tax File Number, or where this does not occur, for their employer to withhold tax. It is not clear why these measures do not properly address any concerns the Government may have in former employees paying their tax in the same way as current employees; and
- for those companies who do not meet the start-up company definition, employees may not be able to readily transfer or sell their shares. This could be the case where private companies restrict the ability of employees to transfer shares outside of a quarantined group of 'related' people and entities, and even for

listed companies whose shares are thinly traded. For employees of those companies, they can still be left in the position where they are required to pay tax in circumstances where they may not be able to easily realise any benefit.

SPECIFIC CONCESSIONS FOR ELIGIBLE START-UP COMPANIES AND OPTIONS/SHARES THAT MEET CERTAIN CONDITIONS

The Government has proposed specific tax concessions where a "start-up company" meets specific criteria. The criteria to be a start-up company includes:

- the company having aggregate turnover of not more than A$50 million per year;
- the company being unlisted; and
- the company being incorporated for less than 10 years.

This criteria will mean that many smaller companies and their employees will be able to take advantage of the potential tax concession.

Where an eligible start-up company issues options or shares to an employee, further requirements need to be met to access the concession, including:

- the equity must be issued for a "small discount"; and
- those options or shares must be held by the employee for at least three years.

From the information released to date it appears that a "small discount" will mean that only:

- "out of the money" (or premium priced) options (i.e. where the exercise price of the options issued is more than the share value at the date of grant); and
- shares which have been issued at no more than a 15% discount,

will be eligible for the tax concession. For employees who are granted options that meet those conditions, taxation of that benefit will be deferred until a sale of the shares. For employees who are granted shares that meet those conditions, the discount will be exempt from income tax.

In either case, where those conditions are met, the maximum period of tax deferral will be extended from the current seven years to up to 15 years. This extension may well recognise that start-up companies generally require a longer period in which to become competitive and ultimately to succeed.

The announcements also indicate that capital gains tax will apply to these scenarios. Although a capital gain can be taxed at the same rate as ordinary income, being taxed as a capital gain enables individuals to potentially access the CGT discount where they hold the relevant equity for more than 12 months and certain other requirements are met. However, any such plan will need to be carefully managed as, in employee share scheme scenarios, the timing of ownership of a share does not start from when an option is granted. Therefore, the exercise of an option and sale of a share within 12 months may not trigger any benefit in relation to the tax rates applicable as the CGT discount will not apply.

As most of the press and industry focus has been on the position in relation to options, we have set out at the end of this article **two examples of how the new tax rules will apply to options** (using the Government's own examples and expanding upon those).

The requirement that only a "small discount" apply to the options or shares seems to indicate that eligible start-up companies wishing to issue options which are immediately "in the money" or which are issued at market value, performance units or rights (which are akin to an option with a zero exercise price or ZEPOs), or shares at a significant discount to employees, will not be able to take advantage of the proposed tax concession. It is not clear why the Government has chosen to limit the potential concession in this way.

VALUATION CHANGES FOR UNLISTED OPTIONS

Recognising the issues which can arise for unlisted companies in determining the relevant "market value", the Government has also indicated that it will update existing 'safe harbour' valuation tables, which are used by unlisted companies to value their options, so that they properly reflect current market conditions. In updating those tables it should not be assumed that reflecting current market conditions may result in lower values being assigned to options. Any increase in the value of options using those tables will increase the tax payable on those options. These changes will not affect the requirement for an unlisted company to determine the market value of its shares at relevant times.

STANDARDISED DOCUMENTATION

The Government has stated that the Australian Taxation Office, together with the Australian Securities & Investments Commission and with industry, will work to develop and approve standardised documentation that will streamline the process of establishing and maintaining an employee share scheme.

While this aspect of the Government's announcement has received less press coverage, it may well prove to be the most significant matter in making it easier for companies (and particularly smaller companies) to implement employee share schemes in the future. If, as is the case in the United Kingdom for some types of arrangements, it is proposed that standardised documentation will be developed, this may well lead to increased certainty for the tax position for participating employees. This can only ease the way for simpler implementation.

OTHER TYPES OF ARRANGEMENTS

The Government's announcement appears to leave the position of other common employee share scheme structures, including loan funded schemes, untouched at this stage. While it is not clear at this stage, these changes may even see the re-introduction to the market of some forms of employee share schemes that have largely disappeared, including bonus sacrifice based plans.

WHAT DOES THIS MEAN FOR COMPANIES?

Once the draft consultation paper and legislation is released, we will get a clearer picture of the practical implications of the proposed changes and the extent to which they differ from the pre-2009 tax rules. We will also have a clearer understanding of whether, as with the 2009 tax changes, there will be transitional rules covering grants already made to employees but where the relevant taxing point occurs after 1 July 2015.

In the meantime, companies should continue to seek expert assistance when setting up a new employee equity scheme or making new offers under an existing scheme to employees in Australia, while keeping abreast of these developments.

We will continue to keep you informed of major developments as further details are released and will be actively involved in the consultation process.

EXAMPLES

Example 1 – Options that are not eligible for the start-up concession

- An employee works for a company that does not meet the eligibility criteria for the start-up concession
- On 1 July 2015, the employee is granted 10,000 options to acquire shares in her employer's company with an exercise price of $5 per option. The employee is granted those options for no consideration (i.e. free).
- Those options can be exercised between 1 July 2018 and 1 July 2019 (i.e. after 3 years) and have been granted under a qualifying employee shares scheme.
- The market value of the underlying shares in her employer's company on 1 July 2015 is $4 per share. As a result, at the time of grant those options are "out of the money", as the exercise price of the options is less than the market value of the shares.
- Although the options are "out of the money" when granted, the options still have a market value. Assuming that each option has a value of $0.50, the total value of the options provided to the employee is $5,000 at the time they are granted. As a result, at the time of grant, the total discount provided to the employee is $5,000, being equal to the market value of the options ($5,000) minus any amount paid by the employee ($0).

Under the current employee share scheme tax rules, and assuming there was no risk that the employee could forfeit the options, the employee would have had to pay income tax on the discount component ($5,000) in the income year that they receive the options (tax year 2015-16). This, of course, would result in the employee paying income tax at a time that they have not realised any value from the options granted to them and before they could exercise the shares (even if they were in the money).

Under the current employee share scheme tax rules, and assuming there was a risk that the employee could forfeit the options (i.e. a real risk of forfeiture) but no disposal restriction, the employee would have had to pay income tax when that risk ceased to apply. The employee would have to pay income tax on the discount component. That discount would be the difference between the then market value of the option and any amount paid by the employee ($0).

Under the **proposed tax rules**, provided that the employee share scheme has been designed to allow for the potential deferral of income tax by participants, **the employee will not be liable to pay income tax on this scheme until the employee exercises the options to acquire shares, unless an earlier taxing point occurs**. The examples provided to date suggest that an earlier taxing point would include where the employee ceases to be employed by the company (as is generally the case under the current rules).

If no disposal restriction exists, and the employee chooses to exercise the options on 30 June 2019, the employee will pay income tax on the difference between the market value of the option at that time and the amount paid to exercise the options. If, for example, the market value of the company's shares at that time was $6 per share, then the market value of the option at that time would be $1 per option (the difference between $6 share price on that day and the exercise price of $5).

If the employee sells the shares in the future, then the employee will be liable for capital gains tax on any further gains in the value of the underlying shares. For example, if the employee sells the shares for $8 per share on 1 July 2020, the employee will be liable in that tax year for capital gains tax on $8 less the sum of the market value of options on the exercise date ($1 per option) and the exercise price of $5 per option.

Generally a restriction on the disposal of the equity will be incorporated into these types of plans as one of the key objectives of an employee share scheme is to retain staff. In addition, private companies will typically restrict the ability of employees to transfer shares outside of a quarantined group of 'related' people and entities. This is a way to extend the tax deferral period (i.e. have a risk of forfeiture run for 12 months and then restrict the disposal, of the option (other than by exercising) and, of the resulting shares for a further period of time).

Example 2 – Options that are eligible for the start-up concession

- An employee works for a small company that meets the eligibility criteria for the start-up concession.
- On 1 July 2015, the employee is granted 10,000 options to acquire shares in her employer's company with an exercise price of $5 per option. The employee is granted those options for no consideration (i.e. free).
- Those options can be exercised between 1 July 2018 and 1 July 2019 (i.e. after 3 years) and have been granted under a qualifying employee shares scheme.
- The market value of the underlying shares in her employer's company on 1 July 2015 is $4 per share. As a result, at the time of grant those options are "out of the money", as the exercise price of the options is greater than the market value of the shares.
- Because those options are "out of the money" at the time of grant, the employee is eligible for concessional treatment under the start-up concession.
- Although the options are "out of the money" when granted, the options still have a market value. Assuming that each option has a value of $0.50, the total value of the options provided to the employee is $5,000 at the time they are granted. As a result, at the time of grant, the total discount provided to the employee is $5,000, being equal to the market value of the options ($5,000) minus any amount paid by the employee ($0).
- Assume that the employee continues being employed by the company throughout the relevant period.

Under the **current employee share scheme tax rules**, the position will be as set out in Example 1.

Under the **proposed tax concessional start-up rules**, the employee will be **able to defer any tax payable on the options until they sell the underlying shares**, unless another earlier taxing point occurs. The examples provided to date suggest that an earlier taxing point would include where the employee ceases to be an Australian tax resident, but unfortunately is silent on whether the employee ceasing to be employed by the company (the most common requirement) will also result in an earlier taxing point (as is generally the case under the current rules).

If the employee sells the shares for more than $5 per share (i.e. for more than the exercise price), then the employee will be liable for capital gains tax for any gain made by her. We assume that if the employee has held the shares for more than 12 months and certain other requirements are met, the 50% CGT discount will apply to the capital gain. On this basis, the tax rate for these types of plans will be half of the tax rate for other plans. However, the rules in relation to the timing of acquisition of the shares needs to be carefully managed to make sure the shares (and not simply the options) are the assets which are held for at least 12 months.

MORE INFORMATION

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