

# 10 Minutes

## on Employee Share Schemes – Draft legislation

**pwc**

January 2015

### **Highlights of the proposed legislation**

*On 14 January 2015, Treasury released for consultation exposure draft legislation on the proposed amendments to the employee share scheme (ESS) tax rules that were previously announced in October 2014 as part of the Government's **Industry Innovation and Competitiveness Agenda**.*

*There are a few surprises contained in the draft legislation but overall the proposed changes should improve the operation of the ESS tax rules. It is however disappointing that the Government has not seized the opportunity to remove cessation of employment as a taxing point under the ESS tax rules – leaving employees to pay tax on unvested shares or rights that they retain on employment.*

*The proposed changes will apply to ESS interests acquired on or after 1 July 2015. Therefore ESS interests acquired before 1 July 2015 continue to be taxed in accordance with the current legislation. There have been no changes proposed to the existing ESS reporting regime.*

01

#### **Improvements to 'rights' based deferred tax schemes**

- Rights based schemes (e.g. options and performance rights) will be eligible to defer taxation until exercise (currently vesting).
- Rights (not shares) which do not provide for a 'real risk of forfeiture' may be able to access tax deferral where the scheme restricts the immediate disposal of the rights and expressly states that deferred taxation applies.

02

#### **Maximum tax deferral period increased**

- The maximum deferral period for schemes that are eligible for tax deferral will increase from 7 years to 15.

03

#### **Significant ownership and voting rights limitations relaxed**

- Under the current law, tax deferral is only available for employees who have less than 5 per cent ownership and voting rights in the company. It is proposed that this condition will be relaxed by doubling the existing 5 per cent limit to 10 per cent.

04

#### **New tax concessions for eligible start-ups**

- Concessions are to be introduced for employees of eligible start-up companies so that taxation can be deferred until sale. The concessions will apply for shares granted at a discount of up to 15 per cent and, options granted with an exercise price greater than or equal to the market value of the underlying shares at grant.

05

#### **Changes to refund provisions**

- It is proposed that the employees will be eligible to obtain a refund of tax (in relation to which income tax has been paid) if the employee decides to let the rights lapse, provided the scheme has not been structured to protect the employees from downside market risk.

06

#### **Valuation of ESS interests**

- The proposed legislation introduces a new power for the Commissioner of Taxation to approve market valuation methodologies.
- The valuation tables contained in the *Income Tax Assessment Regulations 1997* which are used to value unlisted rights will be updated for awards made after 1 July 2015.

# *What the changes mean for you*

## **Re-emergence of salary/bonus sacrifice plans?**

In 2009, the requirement that shares and rights be subject to a real risk of forfeiture to be eligible for tax deferral effectively ended the operation of many salary sacrifice and bonus sacrifice plans. Employees did not want to sacrifice salary or a bonus that had already been earned and make it subject to forfeiture. Although the 2009 changes did allow up to \$5,000 to be salary sacrificed (into shares or rights) without there being a real risk of forfeiture, this amount was too low for many plans which allowed for much greater amounts to be sacrificed.

The proposal to allow rights plans which do not provide for a real risk of forfeiture to access tax deferral where the scheme restricts the immediate disposal of the rights and expressly states that deferred taxation applies should be warmly welcomed. This will enable companies to provide employees with the opportunity to sacrifice salary and/or bonuses into rights to acquire shares.

## **Revival of options?**

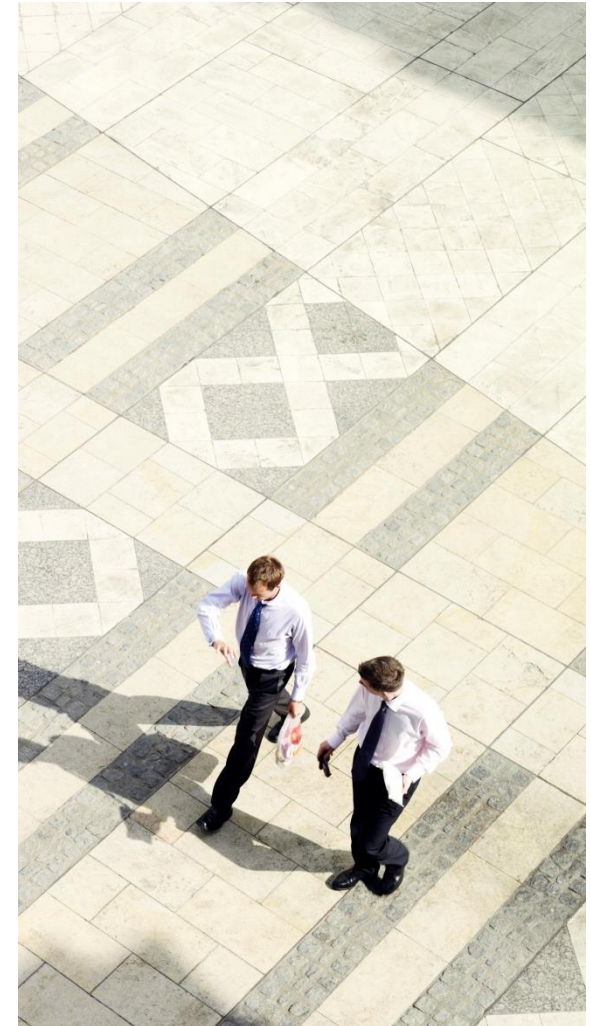
The ability for options to be taxed at exercise once again will be well received by all and will bring Australia back into alignment with the rest of the developed world in regards to the taxation of options.

This change alone will unwind much of the pain caused by the 2009 changes and will also assist companies that do not benefit from the start-up concession to implement arrangements that do not trigger taxation at vesting.

Although the shift to using Performance Rights (i.e. a right to receive a free share that is delivered on vesting) instead of options was well underway before the 2009 tax changes, the 2009 tax changes only increased the attractiveness of Performance Rights as tax typically arises when the employee receives the shares.

However, if the taxing point on options can once again be deferred until exercise, the use options may see a revival. Some companies may also consider structuring Performance Rights as options (commonly referred to as nil-cost options or zero exercise price options) so that employees can control when they obtain any shares they become entitled to receive.

The draft legislation and explanatory material also confirms that the existing application of genuine disposal restrictions which can provide further tax deferral to shares and rights will remain. Accordingly, if the sale of a share acquired on exercise of an option is genuinely restricted, the taxing point will be deferred until the restrictions on sale are lifted.



# What the changes mean for you

## More favourable valuation rules?

Another unexpected surprise is the updated valuation tables contained in the *Income Tax Assessment Regulations 1997* which are used to value unlisted rights. Based on the Board of Taxation's review of these valuation tables that was released in 2010, it was thought that updating the valuation tables would most likely result in the calculation of a higher market value. However, the proposed updated valuation tables typically provide a lower market value in most cases when compared to the existing valuation tables.

Unfortunately, it is proposed that the updated valuation tables will only apply to ESS interests acquired on or after 1 July 2015. Given that options will now generally be taxed at exercise, the proposed new valuation tables will likely only apply to options that are taxable at grant or cessation of employment.

We recommend that the Government consider allowing these proposed valuation tables to be used by employees with ESS interests granted prior to 1 July 2015, but to which a taxing event arises on or after 1 July 2015. This will allow employees to access these potentially more favorable valuation rules going forward.

With regard to the proposed new power for the Commissioner of Taxation to approve market valuation methodologies, it remains to be seen what valuation methodologies will be approved. The cost of valuing shares remains a significant barrier for start-up companies in offering employee share schemes. It is hoped that the valuation methodologies approved by the Commissioner will reduce compliance costs and facilitate the use of employee share schemes.

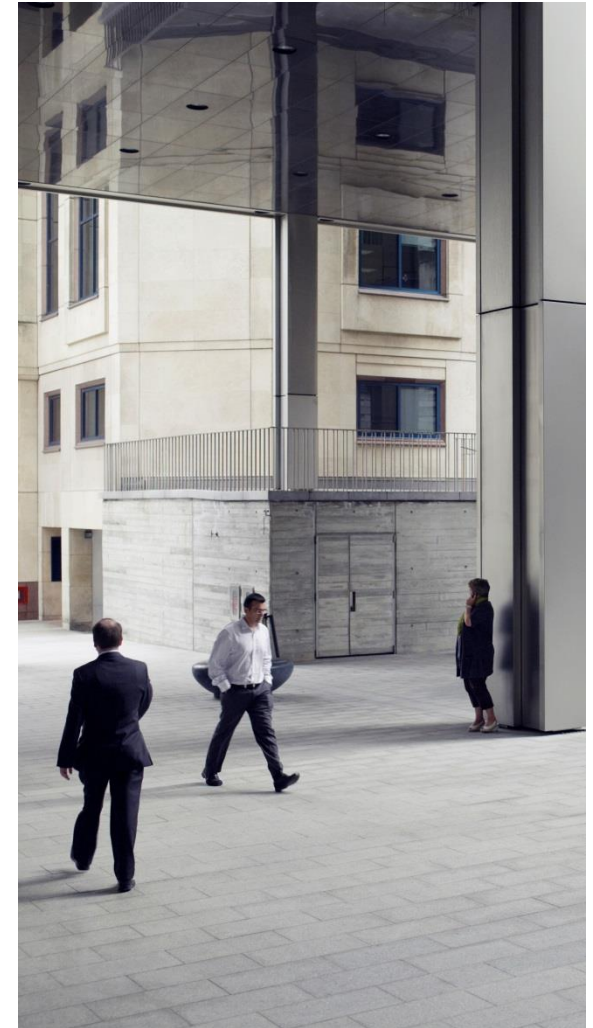
## Start-up concession – restrictive application?

In detailing the conditions that need to be satisfied to access the start-up concession, based on the October 2014 announcement, it was not expected that the shares or rights (or shares and rights offered under another plan) would need to be offered to at least 75 per cent of the permanent employees of the company. This requirement is overly restrictive and will result in limited application of the start-up concession. In many start-up companies, there may only be a few key employees that the company wishes to make an offer to. We recommend that this condition is removed.

The draft legislation confirms that an eligible start-up company must not be listed on an approved stock exchange at the time the employee acquires the ESS interest.

Furthermore, the company in which the ESS interests are granted must be incorporated for less than 10 years before the time the ESS interests are granted. In considering the length of time the company has been incorporated, regard is also given to other companies in the corporate group.

With regard to the requirement that an eligible start-up company has aggregated turnover of less than \$50 million, the draft legislation indicates that this limit is tested over the income year prior to the year in which the ESS interest is acquired. Also, in determining aggregated turnover, regard is had to the turnover of connected and affiliated entities (as defined in Subdivision 328-C of the *Income Tax Assessment Act 1997*).



# *What the changes mean for you*

## **Refund rules – too little too late?**

The proposal to extend the refund provisions so that employees will be eligible to obtain a refund of tax (in relation to which income tax has been paid) if the employee decides to let the rights lapse, will unfortunately come too late for those employees affected by this issue. This issue currently arises for options which are taxed at vesting (even where underwater) and lapse because the options have remained underwater. Under current law, an employee is not entitled to a refund because he/she chooses to let the option lapse. As the proposed new law only applies to awards made on or after 1 July 2015 and the taxing point for options will typically move to exercise, it is unlikely that this change will have much application.

## **Relaxing the ownership and voting rights test**

The proposal that tax deferral may be available for employees who have not more than 10 per cent ownership and voting rights in the company (currently, the limit is 5 per cent) will be welcomed by employees in unlisted entities where the potential to hold a more substantial shareholding in the company is possible. For listed companies, this change will have very limited application.

## **Standardised documentation and safe harbour valuation methodologies - ATO consultation**

The Australian Taxation Office (ATO) has also announced that it will consult with interested parties to identify appropriate safe harbour valuation methodologies to value unlisted shares and to develop standardised documentation that assist companies establish and maintain an ESS. Submissions can be made to the ATO by 9 February 2015.



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## *What should you be doing now?*



**Consider** how the proposed new law may impact the future design of your employee share plans. Are there any opportunities or traps to be aware of?



**Consider** the actions you should be taking between now and the proposed start date of 1 July 2015. For example, if you grant options, where possible, consider deferring new grants until after 1 July 2015.



**Monitor** any future developments, particularly any changes from the exposure draft legislation and the legislation that is introduced into Parliament.



**Get** involved in the consultation process! Comments on the draft legislation and explanatory material can be made up to Friday 6, February 2015. PwC will be making a submission and we welcome your comments.

## *How can PwC help?*

To have a deeper discussion about these issues, please contact:

### *Sydney*

**Norah Seddon**

*Partner*

Ph: (02) 8266 5864

Email: [norah.seddon@au.pwc.com](mailto:norah.seddon@au.pwc.com)

**Marc Bosotti**

*Director*

Ph: (02) 8266 7855

Email: [marc.bosotti@au.pwc.com](mailto:marc.bosotti@au.pwc.com)

### *Melbourne*

**Shane Smailes**

*Partner*

Ph: (03) 8603 6097

Email: [shane.smailes@au.pwc.com](mailto:shane.smailes@au.pwc.com)

**Daryl O'Callaghan**

*Principal*

Ph: (03) 8603 2841

Email: [daryl.ocallaghan@au.pwc.com](mailto:daryl.ocallaghan@au.pwc.com)

**Michelle Kassis**

*Director*

Ph: (03) 8603 5676

Email: [michelle.kassis@au.pwc.com](mailto:michelle.kassis@au.pwc.com)

### *Brisbane*

**Paula Shannon**

*Partner*

Ph: (07) 3257 5751

Email: [paula.shannon@au.pwc.com](mailto:paula.shannon@au.pwc.com)

### *Adelaide*

**Maria Ravese**

*Partner*

Ph: (08) 8218 7494

Email: [maria.ravese@au.pwc.com](mailto:maria.ravese@au.pwc.com)

### *Perth*

**Lisa Hando**

*Partner*

Ph: (08) 9238 5116

Email: [lisa.hando@au.pwc.com](mailto:lisa.hando@au.pwc.com)

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