10 minutes on...

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What you need to know about the proposed changes to employee share schemes

Employee Share Schemes

The first step in the right direction

pwc

The first step in the right direction

On Tuesday 14 October 2014, the Australian Government released the *Industry Innovation and Competitiveness Agenda* which includes proposed changes in relation to the taxation of Employee Share Schemes (ESS) to "bolster entrepreneurship in Australia and support innovative start-up companies".

These proposed changes, which are intended to apply to new awards made from 1 July 2015, are welcomed as a first step in unwinding the changes made by the former Australian Government in 2009 which had an adverse impact on the operation of employee share schemes in Australia.

In particular, the proposed changes should remove the disincentive for employers to use options and provides a specific regime for start-up companies to encourage these companies to start and stay in Australia and use employee share schemes to incentivise staff.

At this stage, only limited information on the proposed changes has been made available in the Government announcement, the Industry Innovation and Competitiveness Agenda paper and the accompanying fact sheet. More detailed information may only be available when the Treasury releases its consultation paper on the proposed changes (release date currently unknown).

Highlights

- ***Reverting the taxing point on most employee options back to exercise (currently, the taxing point typically arises at vesting)***
- ***Providing concessional treatment for start-ups which may allow for certain options and shares to only be subject to capital gains tax when the actual shares are sold***

Further changes still needed

Although the proposed changes are a good first step, PwC believes that further changes to the employee share scheme tax rules should be made.

The two key remaining disincentives arising from the taxation system that the Government should address are:

- cessation of employment as a taxing point under employee share schemes, and
- how employees are taxed when the shares in their employer are not readily traded such as where the employers are private companies or small cap listed companies (but not a start-up as defined in the changes announced by the Government).

When employees leave their job, they should not have to pay tax on the current market value of their unvested shares or options as they often cannot sell their shares to pay their tax at this time. The proposed changes did not address this issue and cessation of employment remains a taxing point.

Privately owned businesses play a significant role in the economy. Almost 70 per cent of businesses in Australia are privately owned and collectively they comprise 66 per cent of the economic output and two thirds of employment in Australia. Many shares in privately owned business and small cap listed companies are not able to be readily traded.

The current employee share scheme rules mean that employees of such companies who receive shares in their employer could pay tax on the value of the shares at a time when they cannot dispose of the shares. This means that many private companies and small cap listed companies do not introduce such plans, limiting employee participation in a large part of Australia's economy. The proposed changes did not address employee share schemes in this sector of the economy.

We encourage the Government to continue reforms in relation to the taxation of employee share schemes especially in relation to:

- ***Removal of cessation of employment as a taxing point***
- ***Taxation of awards in private companies and small cap listed companies***

The changes that have been announced

The following changes to improve the taxation arrangements for employee share schemes were contained in the Joint Press Release from the Prime Minister, the Treasurer and the Minister for Small Business, the *Industry Innovation and Competitiveness Agenda* and the accompanying fact sheet:

- Discounted options will generally be taxed when they are exercised (converted to shares), rather than at the grant or vesting dates. This is a reversal of the 2009 changes to the ESS tax rules and is intended to apply to all companies.
- Options or shares provided at a "small discount" by eligible start-up companies, will not be subject to up-front taxation as long as the shares or options are held by the employee for at least three years. Criteria to be a "eligible start-up company" will include the company having aggregate turnover of not more than $50 million, it being unlisted and being incorporated for less than 10 years.
- To give start-ups more time to be competitive and succeed, the Government will extend the maximum time for tax deferral from 7 years to 15 years for start-up companies only.
- 'Safe harbour' valuation tables, which are used by companies to value their options, will be updated so they reflect current market conditions.
- The integrity provisions introduced in 2009 and the $1,000 up-front tax concession for employees who earn less than $180,000 per year will be retained.
- The Australian Taxation Office (ATO) will work with industry to develop and approve standardised documentation that will streamline the process of establishing and maintaining an ESS. The Australian Securities & Investments Commission (ASIC) will be consulted, given its oversight of disclosure documents involving the offer of financial products.

Matters to consider for all companies

Given the lack of detail surrounding the proposed changes, the information currently available raises a number of questions on how the changes will be applied and the impact on ESS awards.

A real risk of forfeiture no longer required?

The Government has stated that it will reverse the 2009 tax changes for all companies such that options will generally be taxed when they are exercised (converted to shares), rather than at the grant or vesting dates. In addition, the Government has stated that it will retain the integrity provisions that were introduced in 2009, without specifically naming the integrity provisions other than in relation to the $1,000 exemption for shares in certain circumstances.

The accompanying fact sheet that was released with the announcement also gives an example (Example 2) of options that were not subject to a real risk of forfeiture being subject to tax at grant under the current rules and, provided the employee share scheme is a deferred tax scheme, being subject to tax at exercise after the proposed changes. This raises the question as to whether the requirement to have a real risk of forfeiture will be retained.

The concept of there being a "real risk of forfeiture" was a fundamental condition for awards to be eligible for tax deferral under the 2009 tax changes and it is likely to be an integrity measure that the Government would seek to retain in order for an ESS award to be eligible for tax deferral.

That said and based on the information in the fact sheet, at this stage it is unclear whether or not this condition will be removed and, if so, whether it would be removed for all ESS awards or only for options.

In Example 4 of the fact sheet, it suggests that shares which are not eligible for the start-up concession must be subject to a real risk of forfeiture to be eligible for tax deferral. If only options no longer require there to be a real risk of forfeiture, we could move from a position where options were adversely taxed compared to other instruments to a position where options potentially receive preferential treatment compared to other instrument.

In our view, it is likely that the real risk of forfeiture would be retained for all ESS awards however the information released raises the above question and clarity should be obtained in the consultation with Government in relation to the changes.

Matters to consider for all companies (cont.)

Higher taxable values for options determined under revised valuation tables?

The Government has stated that it will update the 'safe harbour' valuation tables, which are used by companies and employees to value their options, so that the valuation tables reflect current market conditions. Based on the Board of Taxation's *Review into elements of the taxation of employee shares scheme arrangements* that was released in 2010, updating the valuation tables to reflect current market conditions, which would take into account matters such as volatility and dividend yields, would most likely have the result of having an increased value assigned to certain options.

Increasing the value of options will increase the tax payable on those options when the value is determined using the valuation tables. On the basis that options will now generally be taxed at exercise, practically this change will likely only have an impact on taxpayers where the valuation of the options is taxable at grant, vesting (for pre-1 July 2015 awards), upon cessation of employment or at the end of the maximum deferral period of 7 years.

Cessation of employment to remain a taxing point?

Disappointingly, it seems that cessation of employment will remain as a taxing point. Although there is no specific discussion of tax on cessation of employment, the examples in the fact sheet includes footnotes that indicate that an earlier taxing event may arise if the employee "stops being an employee".

It is hoped that during the consultation process, this most vexing taxing point will be removed. In many cases, employees who cease employment and are eligible to retain their ESS awards (most typically in the event of redundancy) are often required to wait until the end of the specified vesting period to receive the shares. Having to pay income tax at a time when the employee has not received the shares can create a significant tax burden on employees and is akin the current situation where options are taxed at vesting - an outcome that the Government has acknowledged in these proposed changes to be inappropriate.

Types of options covered?

There are many different types of "options" that are used in the market, including market value options (exercise price equal to the share price at grant), nil cost or zero exercise price options and premium exercise price options (exercise price greater than the share price at grant). Will the proposed changes apply to all these types of options?

Furthermore, some options are currently considered to be "indeterminate rights" under the existing employee share scheme tax rules. For example, an equity-settled stock appreciation right ("SAR") is considered an indeterminate right. Will these types of awards now also be able to defer tax until exercise?

Matters to consider for all companies (cont.)

Implications for genuine disposal restrictions?

Under the existing rules, the deferred taxing point of an ESS award can be further deferred whether there are genuine disposal restrictions on the exercise of the award or the disposal of the underlying share.

What will be the implications for options that are subject to genuine disposal restrictions? Will the taxing point be able to be deferred until after exercise where the resulting shares are subject to exercise conditions / disposal restrictions that apply after the award has been exercised?

Revival of salary sacrifice plans?

The 2009 tax changes almost eliminated the use of bonus sacrifice and salary sacrifice plans. If the condition that there be a real risk of forfeiture is removed, for all ESS awards or only for options (as discussed above), we may see a re-emergence of salary and bonus sacrifice plans.

Matters to consider for start-up companies

The proposed changes contain concessional tax treatment for certain shares and options provided by start-up companies to employees. An “eligible start-up company” will include a company having aggregate turnover of not more than $50 million, it being unlisted and being incorporated for less than 10 years.

Provided the shares or options are held by employees for at least three years, the Government proposes for the shares and options to not be subject to taxation at grant, vesting or exercise, but to defer tax until the shares are sold (unless any earlier taxing point occurs, for example the cessation of employment). Tax will only be able to be deferred for up to 15 years. The examples in the fact sheet indicate that, when the shares are sold, the “gain” will be subject to Capital Gains Tax (CGT) rather than income tax.

Again, given the lack of detail surrounding the proposed changes for start-ups, the information currently available raises a number of questions on how the concessional treatment for start-ups will be applied.

Start-up concessions – further tax concession for shares awards?

Under the proposed start-up concessions, employees with eligible options may defer tax until he/she sells the underlying shares. The amount subject to capital gains tax on sale will be the difference between the sales proceeds received for the share (say $8) and the amount paid by the employee to acquire the share, i.e. the exercise price (say $5). Therefore the amount subject to CGT will be $3. The information available does not address whether the CGT discount would be available for such capital gains.

In the case of shares, where the employee purchases shares at a discount of (say) 15% (purchase of share worth $5 for $4.25), the discount is likely to be exempt from tax. When the employee sells the share for $8, the employee would only be subject to CGT on $3 being the difference between the sales proceeds ($8) and the market value of the shares at purchase ($5), despite only having paid $4.25 to acquire the share.

The introduction of a special regime for start-up companies is a welcome reform.

Matters to consider for start-up companies (cont.)

Essentially, despite the fact that the “discount” on both the option and share are not being subject to income tax, for CGT purposes, the discount on the option is not included in the cost base but the “discount” on the share is included in the cost base.

Start-up concession for options – only applicable to premium priced options?

While full details on the start-up concessions for options are not yet available, the fact sheet indicates that a condition for the options to be eligible for concessional treatment is that the options are not ‘in the money’.

In other words, the exercise price that is be paid by the employee to acquire the share must be greater than the market value of the share at the time of grant. These types of options are commonly referred to as premium priced options.

It is unknown why the concessional treatment should only apply to premium-priced options and not to other options, such as market value options where the exercise price is equal to the market value of the shares at grant.

Limit to start-up concessions?

The announcement suggests that the concessions for start-ups will apply to “options or shares that are provided at a small discount”. The information released does not contain any specified limit in regards to options, but in the case of shares it indicates that the discount must not be more than 15% of market value.

How are the shares valued?

A significant barrier to offering employee share scheme in start-up companies is the cost associated with determining market value of a share in a particular company. Before it possible to calculate the discount or to use safe harbour valuation tables, the market value of the company’s share needs to be determined. Until there is a cost effective means for a company to determine the market value of its shares, this will remain a barrier to operating employee share plans.

Impact of securities law

In many cases, legal rules rather than tax rules can impede companies from offering employee share schemes. The Government has indicated that ASIC will be consulted in preparing standardised documentation, but it is imperative that changes to securities law are made in conjunction with the proposed tax changes to the ESS rules to ensure that employee share plans are effective for start-up companies, both from a tax and legal perspective.

What should a company do in the meantime?

- ***Consider*** how these changes 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 award options, where possible, consider deferring new grants until after 1 July 2015.
- ***Monitor*** any future developments, particularly the release of Treasury's consultation paper on the proposed changes.
- ***Start*** thinking about how you would like to see the changes implemented and any further changes that you would like to see introduced. Get involved in the consultation process!

How can PwC help?

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

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