

Improving taxation arrangements for employee share schemes

International research suggests that companies in which employees have an ownership interest are more productive than those that do not. In addition, Employee Share Schemes (ESS) are used in many countries as a way of attracting and retaining high-quality staff for innovative start-up companies by providing them with a financial share of the potential upside from success of the company.

In Australia, certain changes introduced in 2009 to the tax treatment of options acquired through an ESS detracted from the goal of commercialising good ideas in Australia. The changes mean the Government now taxes options when they are provided to the employee (if there is no risk the employee will forfeit the options) rather than when they are converted into shares (exercised), and so before the employee can generally take practical steps to realise any gain to pay the tax. This effectively ended the provision of options under an ESS, particularly by start-ups. Indeed, successful entrepreneurs have stated that the tax treatment of ESS options has reduced their ability to find talent in Australia and contributed to driving them offshore.

The Government will improve the tax treatment of ESS to facilitate better alignment of interests between employers and their employees, and to stimulate the growth of high technology start-ups in Australia by helping small unlisted companies be more competitive in the labour market.

The Government will reverse for all companies the changes made in 2009 to the taxing point for options, while retaining the integrity provisions that were introduced at that time. The existing up-front tax concession, which exempts from income tax the first \$1,000 of ESS interests given to an employee who earns less than \$180,000 per annum, will also be retained.

Employees who are issued with options under deferred tax schemes will generally be able to defer tax until they exercise the options, rather than having to pay tax when they receive the options. In addition, the Government will extend the maximum time for tax deferral from seven years from acquisition of interests to 15 years, allowing more time for start-ups to succeed. The Government will also update the safe harbour valuation tables used to value unlisted rights, to ensure they reflect current market conditions.

A further concession will also be made available to eligible start-ups, which will allow them to issue to their employees options under certain conditions or shares at a small discount, and have taxation deferred until sale or the small discount exempt from tax. The shares or options would need to be held for at least three years. Criteria will be applied to define eligible start-ups, including turnover of not more than \$50 million, being unlisted and being incorporated for less than 10 years.

In addition, the Australian Taxation Office 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 will be consulted, given their oversight of disclosure documents that involve the offer of financial products.

The Treasurer will consult with industry to ensure that the draft legislation delivers the intended outcome, with the legislation intended to come into effect for shares or options provided from 1 July 2015.

Employee Share Schemes

An employee share scheme is a scheme where shares or options in a company are provided to an employee in relation to their employment. A share provides a shareholder with an ownership share in a company. An option is the right to buy a share in a company at some point in the future.

Example 1 – Options that are eligible for the start-up concession

Kerry works for a small company that meets the eligibility criteria for the start-up concession*. On 1 July 2015, Kerry is given 10,000 options to purchase shares in her employer's company for \$5 per share (that is, the exercise price is \$5) between 1 July 2018 and 1 July 2019 under a qualifying employee shares scheme.

The market value of shares in her employer's company on 1 July 2015 is \$4 per share (which is less than the exercise price of the options) so the shares are 'out of the money'. Because the shares are not 'in the money' (which occurs when the exercise price is lower than the market value of the shares), Kerry is eligible for concessional treatment under the start-up concession.

Kerry does not pay anything for the options, but they are worth \$0.50 each (total value of \$5,000) when they are provided to her. The total discount provided to Kerry is \$5,000, equal to the market value of the options (\$5,000) minus any amount paid by Kerry (\$0).

Under the old rules, and assuming there was no risk that Kerry could forfeit the options, Kerry would have had to pay income tax on the discount component (\$5,000) in the income year that she received the options (2015-16).

Under the new concessional start-up rules, Kerry will be able to defer any tax on this ESS arrangement until she sells the underlying shares, unless another taxing point** occurs first. If Kerry sells the shares for more than \$5 per share (the exercise price, which will also likely be her cost base for CGT purposes), she will be liable for capital gains tax upon sale of those shares. In this example, if Kerry sells the shares for \$8 per share, she will pay CGT on her gain of \$3 per share when she sells the shares (the sale price of \$8 minus what she paid for each share, \$5).

*Eligibility criteria include: the 3 year minimum holding period; company having aggregated turnover of not more than \$50 million; being unlisted; and being incorporated for less than 10 years.

**Another taxing point will occur if a non-sale CGT event occurs to the options or shares before the sale event occurs (e.g., Kerry stops being an Australian resident taxpayer).

Example 2 – Options that are not eligible for the start-up concession

Kate works for a company that does not meet the eligibility criteria for the start-up concession. On 1 July 2015, Kate is given 10,000 options to purchase shares in her employer's company for \$5 per share (that is, the exercise price is \$5) between 1 July 2018 and 1 July 2019 under a qualifying employee share scheme. Kate does not pay anything for the options, but they are worth \$0.50 each (total value of \$5,000) when she receives them. The total discount provided to Kate is \$5,000, equal to the market value of the options (\$5,000) minus any amount paid by Kate (\$0).

Under the old rules, and assuming there was no risk that Kate could forfeit the options, Kate would have had to pay income tax on the \$5,000 discount provided in the 2015-16 income year – the year in which she was provided the options. This is despite the fact that Kate cannot use the options to purchase shares (exercise the options) until 1 July 2018.

Under the new rules, Kate will not be liable to pay income tax on this ESS arrangement until she converts the options to shares (exercises the options), provided the employee share scheme is a deferred tax scheme and not an upfront tax scheme (as determined by the governing rules of the scheme)*. If Kate chooses to exercise the options on 30 June 2019, she will pay income tax on the difference between the market value of the option at that time (say \$1 per option (the difference between \$6 share price on that day and the exercise price of \$5) and the amount she paid to acquire them (in this case, nil). Kate will be liable for capital gains tax on any further gains in the value of the underlying shares when she sells the shares. For example, if Kate sells her shares for \$8 per share on 1 July 2020, she will be liable, in the 2020-21 income 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 share.

*Another taxing point will occur if Kate stops being an employee or the maximum time period is exceeded.

Example 3 – Shares that are eligible for the start-up concession

John works for a small company that meets the eligibility criteria for the start-up concession*. This means that John's employer can offer him shares through an ESS at a discount of up to 15 per cent relative to market value, and have that discount exempt from income tax. John's employer offers John 10,000 shares that are valued at \$1 per share

(\$10,000 worth of shares) in their company for \$8,600 ($\$10,000 \times 0.86$) which is a 14 per cent discount on market value.

John accepts the offer, and purchases \$10,000 worth of shares for \$8,600. As long as the scheme requires that John holds the shares for at least three years, the \$1,400 discount will be exempt from income tax. Capital gains tax (CGT) will be payable if John sells the shares for more than \$1 per share on the difference between the sale price and \$1.

*Eligibility criteria include: the 3 year minimum holding period; company having aggregated turnover of not more than \$50 million; being unlisted; and being incorporated for less than 10 years.

Example 4 - Shares that are not eligible for the start-up concession

No Risk of Forfeiture

Tom is given 1,000 shares in his employer's company under an ESS on 1 July 2015. The shares are provided at no cost to Tom, but are worth \$4 each when he is given them (total market value of \$4,000). If there is no risk that Tom will forfeit the shares, then he will pay income tax up-front (in the 2015-16 income year) on the discount provided on those shares. In this case, the discount will be \$4,000, equal to the market value of the shares when provided (\$4,000) minus any amount paid by Tom (\$0).

No risk of forfeiture and employee earns less than \$180,000

If Tom earns less than \$180,000 in the 2015-16 income year, he may be eligible to receive the first \$1,000 worth of discounts on ESS shares (or options) tax-free. This would reduce the taxable discount on his shares to \$3,000 in 2015-16.

Risk of Forfeiture

If there is a risk that Tom will forfeit the shares (for example, Tom must meet a performance target before being able to sell the shares) then he will become liable to pay tax once that risk no longer exists (for example, the performance hurdle is met and there are no restrictions on disposal). At that time, the shares are worth \$5 each and Tom will pay income tax on the difference between the acquisition cost and the market value of the share at that time*.

Capital Gains Tax

In all cases, Tom will be liable to pay capital gains tax when he sells the shares, on the difference between the sale price and the market value of the shares at the time of the ESS taxing point.

*Another taxing point will occur if Tom stops being an employee or the maximum time period is exceeded.

Summary of taxing points for options and shares provided by a qualifying employee share scheme under the new arrangements

	Options eligible for start-up concession	Options NOT eligible for start-up concession	Shares eligible for start-up concession	Shares NOT eligible for start-up concession
Acquisition Details	10,000 options, provided for free. Exercise price is \$5 and the options have a market value of \$0.50. The market value of the shares at the time the options are issued is \$4, and at exercise the market value is, say, \$6.		10,000 shares, provided for \$9 each, with a market value of \$10 each.	
Sale Details	Sold for \$8 per share	Sold for \$8 per share	Sold for \$15 per share	Sold for \$15 per share
What is the value of the discount?	The discount is \$5,000 [10,000 x (\$0.5-\$0)]. The option is 'out of-the money' and in an eligible start-up so tax can be deferred.	The discount is \$5,000 [10,000 x (\$0.5-\$0)].	The discount is \$10,000 [10,000 x (\$10-\$9)]. The discount is 10 per cent (which is less than 15 per cent), so tax can be deferred.	The discount is \$10,000 [10,000 x (\$10-\$9)].
When is tax paid? ¹	At the time of sale of the underlying shares – as a capital gain (unless another CGT event occurs earlier).	At the time of exercise of the option (unless another deferred taxing point occurs first).	At the time of sale as a capital gain (unless another CGT event occurs earlier).	At the time of acquisition of the share, unless there is a risk of forfeiture, in which case tax is deferred. However, a \$1,000 concession may be available if the employee is earning less than \$180,000 and there is no risk of forfeiture.
What tax is paid?	The discount is not itself subject to income tax. CGT will instead apply on \$30,000 [10,000 x (\$8 - \$5)] in the financial year that the shares are sold.	Income tax is paid on the difference between the market value of the option and the amount paid by the employee for the option (i.e. 10,000 x (\$6-\$5-\$0)). CGT will be payable when the shares are sold on the difference between the sale price and the market value at the exercise date (i.e. 10,000 x (\$8 - \$6)).	The discount is exempt from income tax and market value of the share at acquisition will be part of the cost base for CGT purposes. CGT will be paid upon sale on the difference between the sale price and the market value at acquisition (i.e. 10,000 x (\$15-\$10)).	If there is no risk of forfeiture, income tax is paid on \$9,000 (that is, \$10,000 discount less the \$1,000 concession) in the year the share is received. CGT will be paid upon sale on the difference between the sale price and the market value at acquisition (i.e. 10,000 x (\$15 - \$10)).

¹ For both the start-up and non-start-up concession, an ESS can be established as either a deferred tax or upfront tax scheme (this is to be determined by the scheme's governing rules).