



**Australian Government**

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**The Treasury**

# **REFORM OF THE TAXATION OF EMPLOYEE SHARE SCHEMES**

Consultation Paper

The Treasury

June 2009

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## CONSULTATION PROCESS

### **Making Comments**

The Government is seeking submissions and comments on this paper by **12 June 2009**.

Comments can be sent to:

**Manager  
Philanthropy and Exemptions Unit  
Personal and Retirement Income Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600**

Or e-mailed to: [ESSreforms@treasury.gov.au](mailto:ESSreforms@treasury.gov.au)

For inquiries, please call either:

**Sandra Roussel on (02) 6263 3357  
Chris Leggett on (02) 6263 3208**

### **Format for submissions**

Interested parties are invited to comment on the exposure draft bill and explanatory materials. While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

### **Confidentiality**

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

# REFORM OF THE TAXATION OF EMPLOYEE SHARE SCHEMES

## INTRODUCTION

1. The Treasurer announced in the 2009 Budget that the Government will better target eligibility for the employee share scheme tax concessions and reduce opportunities for tax avoidance.
  - 1.1. The measure was estimated to provide an additional \$200 million over the forward estimates. It formed part of a package of measures which were designed to improve fairness and integrity in the tax system, and yield savings needed to support the deteriorating fiscal position caused by the global recession.
  - 1.2. Under the arrangements announced in the 2009 Budget, all discounts on shares and rights provided under an employee share scheme would be assessed in the income year in which the shares and rights are acquired.
  - 1.3. It was also announced that access to the \$1,000 upfront tax exemption would be limited to those employees with a taxable income of less than \$60,000 after adjustment for fringe benefits, salary sacrificed superannuation contributions and negative gearing losses.
  - 1.4. The Budget measure was designed to reform the current tax arrangements, which involve excessive concessionality and provide scope for losses to Commonwealth revenue through avoidance or confusion as to the taxpayer's obligations.
  - 1.5. The measure was announced to have effect from 7:30pm on 12 May 2009.
2. The Budget measure gave rise to considerable public reaction and representations. The main concerns were that:
  - the \$60,000 income threshold may be too low;
  - upfront taxation may be too harsh a solution to address the acknowledged concerns; and
  - evasion and avoidance concerns can be addressed in other ways.
  - 2.1. Information which came to light in response to the Budget measure suggests that the acknowledged evasion and avoidance problems may be larger than was previously apparent.
3. On 24 May 2009, the Treasurer and the Assistant Treasurer announced that the Government would consider alternatives, and outlined the key principles to underpin the consultation process.
  - 3.1. This process will seek submissions on concerns with the existing and announced arrangements, and on proposed alternative solutions to address the identified problems. This process will allow the wider public to provide the Government with comprehensive feedback on the new framework for the taxation of employee share schemes.

- 3.2. The Treasurer and the Assistant Treasurer noted that this paper will canvass options including:
- the reporting requirements which should be applied to address tax avoidance concerns, such as the application of withholding arrangements or enhanced Tax File Number (TFN) reporting;
  - the level of the income threshold for accessing the \$1,000 tax exemption for upfront taxation, to ensure the continued availability of employee share schemes for low and middle income employees;
  - whether there are circumstances under which it may be appropriate to provide for the deferral of taxation, the period of deferral and what those limited circumstances would be (such as when there is a real risk of forfeiture); and
  - whether the tax law provisions which determine the market value of discounted and deferred shares or rights result in undervaluation.
4. This consultation paper outlines a number of issues, and provides a point of reference for public submissions on this measure.
5. The taxation of discounts on employee share scheme shares and rights on acquisition will remain the Government's starting principle. However, the Government will provide concessional tax treatment for particular schemes. The concessions are in the form of a tax exemption or tax deferral.
6. The Government proposes to modify the 2009 Budget measure as announced:
- to raise the income threshold for the \$1,000 tax exemption to \$150,000;
  - to introduce a limited deferral of the taxing point for some schemes;
  - to introduce an annual reporting requirement and associated withholding arrangements by companies that participate in these schemes;
  - to review the existing rules for valuing discounted and deferred shares and rights; and
  - to modify the rules relating to the refund of income tax for forfeited benefits.
7. These proposed modifications deal with the compliance problems as well as the problems of excessive concessionality. Whilst the proposed reporting requirements can address some of the compliance problems, tightening of the conditions for deferral is also needed to address problems with the existing law, such as the artificial deferral of taxation.
8. To assist in focussing comment on the proposed new framework for the taxation of employee share schemes, the Government has also released draft legislation containing the core rules that will apply under the new framework. Certain minor consequential amendments will follow in due course.
9. The Government is seeking submissions and comments on this paper by 12 June 2009.

## BACKGROUND

### Nature of an employee share scheme

10. The general purpose of an employee share scheme is to align employee's interests with those of their employer so that employees benefit directly when the company does well and employers benefit through having a more committed and motivated workforce. An employee share scheme provides employees with a financial interest in the company they work for through the distribution of shares in that company. The employee may be given shares directly, they may be given rights to shares, or they may be given securities that are related to shares.

### Operation of existing law

11. Under the general income tax law, if an employee is provided with shares or rights under an employee share scheme, any discount that the employee receives by acquiring the shares or rights below the market price is a benefit relating to employment and so would usually be considered income of the employee. However, the fringe benefits law would also assess that discount (generally as a property fringe benefit under Division 11 of Part III of the *Fringe Benefits Tax Assessment Act 1986*). Where fringe benefit tax applies, the income tax law would treat the discount as non-assessable non-exempt income (see section 23L of the *Income Tax Assessment Act 1936* (ITAA 1936)) to avoid double taxing the benefit.
12. However, Division 13A of Part III of the ITAA 1936 provides a specific regime which brings the discount to account as assessable income in the year the employee acquires the share or right (see subsections 139B(1) and (2) of the ITAA 1936). Double taxing is avoided because the fringe benefits law excludes benefits assessed under Division 13A (see paragraph (ha) of the definition of 'fringe benefit' in section 136 of the *Fringe Benefits Tax Assessment Act 1986*).
13. Division 13A starts by taxing all discounts upfront. However, an employee participating in a qualifying<sup>1</sup> employee share scheme can, subject to certain conditions, choose one of two tax concessions on the discount they receive – the 'upfront concession' or the 'tax-deferred concession'.

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<sup>1</sup> Non-qualifying schemes are taxed upfront. Qualifying schemes must satisfy the following relevant requirements: that a share or right is acquired under an employee share scheme; that the share is in your employer; that the shares are ordinary shares; that at least 75 per cent of the permanent employees of the company were entitled to acquire shares under any employee share scheme of the employer; and that after acquiring the share, the employee does not hold more than either 5 per cent of the total shares in the employer or more than 5 per cent of the voting rights. Employees receiving shares or rights under a qualifying share scheme generally defer taxation unless they expressly elect to pay tax upfront.

- 13.1. Under the upfront concession<sup>2</sup>, the employee elects to be taxed on the discount in the year they acquire the shares or rights. However, the total of the discount included in the employee's assessable income is reduced by \$1,000 (see section 139BA). The reduction is a tax concession. Any subsequent capital gains on the disposal of the shares or rights are subject to capital gains tax (CGT), and the 50 per cent CGT discount may apply.
- 13.1.1. Employers who provide shares or rights eligible for the upfront concession can deduct up to \$1,000 in respect of each employee to whom shares or rights are provided in that income year. Since discounts provided on shares and rights are in the nature of remuneration, a tax deduction is provided to the employer so there is equivalence between providing this form of equity-based remuneration and paying cash.
- 13.2. Under the tax-deferred concession<sup>3</sup>, there is no \$1,000 exemption but the employee defers paying tax on the discount until the earliest 'cessation time' (see subsection 139B(3)). A cessation time occurs:
- when restrictions on sale are lifted;
  - when the employee sells the shares or exercises the options;
  - when the employment ceases; or
  - 10 years after the shares or rights were acquired.
- 13.2.1. Any gain on the shares or rights (before the cessation time) is included in assessable income at the cessation time. Therefore, the CGT discount is not available to gains accrued before the cessation time. Capital gains accrued after the cessation time remain subject to CGT, including the CGT discount, if available.

## **PROBLEMS WITH THE EXISTING LAW**

14. The Budget measure was designed to deal with the current tax arrangements applying to employee share schemes, which involve excessive concessionality and provide scope for losses to the Commonwealth revenue through evasion, avoidance or confusion as to the taxpayer's obligations.
15. Division 13A of Part III of the ITAA 1936 is complex, reflecting the subject matter. The complex, technical and flexible nature of existing employee share scheme arrangements has resulted in a significant amount of revenue lost through misapplication of the law and deliberate evasion.

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<sup>2</sup> To be eligible for the \$1,000 exemption under the existing law, the shares or rights provided to the employee: must meet all of the relevant conditions for a qualifying scheme; must be subject to no risk of forfeiture; cannot be disposed of for a minimum of three years (unless employment ends earlier); and must be acquired under a scheme that is operated on a non-discriminatory basis (including any financial assistance provided within it).

<sup>3</sup> The tax deferred concession is the default for qualifying employee share schemes if the employee does not elect to be taxed upfront.

- 15.1. The Australian Taxation Office (Tax Office) has estimated the amount of lost revenue to be up to \$100 million per year.
16. Given the evidence of avoidance, it is clear that the existing law is not achieving its policy objective of promoting the alignment of the interests of shareholder and employees in a consistent and cost effective way.
- 16.1. A discussion paper recently issued by the Australian Prudential Regulation Authority (APRA) on sound executive remuneration practices raises other concerns: that some employee share schemes provide inappropriate incentives for senior management and directors.
17. The APRA paper proposes rules for prudentially regulated institutions to address these other concerns, which are discussed in the next section. It is possible that excessive concessionality in the tax area magnifies these other concerns.
18. In the tax area, the Tax Office has identified compliance problems where taxpayers:
- retrospectively attempt to elect to be taxed upfront on the 'discount' so that they can gain access to the CGT discount for gains accruing since acquisition;
  - fail to include the value of the 'discount' in their assessable income at the cessation time; and
  - incorrectly apply the CGT rules to the 'discount' instead of including it in their assessable income under Division 13A.
19. The Government sought to address the retrospective election issue in the 2008 Budget. However, the effectiveness of that limited change is not yet known.
20. In addition to the compliance problems, it has also been acknowledged that there are integrity problems with the existing tax treatment, for example, the taxing point can be artificially extended to further delay taxation.

## **Cameos**

21. The following case studies illustrate some inappropriate behaviours that the Tax Office has identified when reviewing the tax affairs of participants in employee share schemes.

### **Case study 1**

- The taxpayer acquired options in the 2002, 2003 and 2005 income years. The taxpayer did not elect to be taxed upfront, thus deferring any tax liability to a future time.
- In the 2004 and 2005 income years the taxpayer exercised some of the options but did not include any discounts relating to the options in their 2004 and 2005 tax returns and did not pay any tax on the discounts.



- In the 2005 income year the taxpayer ceased employment and exercised all their remaining options. The taxpayer did not include any discount from the exercise of the options in their 2005 tax return and did not pay any tax on the discount.
- An audit was conducted as part of the Tax Office's Executive and Directors Compliance Project.
- Additional tax payable was \$439,733.

## **Case study 2**

- The taxpayer acquired options in the 2004 income year. The taxpayer did not elect to be taxed upfront, thus deferring any tax liability to a future time.
- In the 2005 income year the taxpayer exercised some of the options and immediately sold the shares.
- The taxpayer did not include any discount relating to the options in their tax return for the 2005 income year.
- Instead the taxpayer incorrectly included a capital gain in their tax return for the 2005 income year and applied the 50 per cent capital gains tax discount.
- An audit was conducted as part of the Tax Office's Executive and Directors Compliance Project.
- Additional tax payable was \$580,340.

## **Equity-based remuneration**

22. In response to the global financial crisis, the Government requested APRA to look at ways to minimise the misalignment of incentives that have promoted excessive risk-taking by company executives. Further background and information on the G20/APRA review of executive remuneration is at Appendix C.
23. APRA does not promote the use of equity-based remuneration over cash but notes that equity-related benefits for executives can be useful as performance rewards. Taking a personal stake in an institution can increase the incentives for an executive to preserve and enhance shareholder value.
24. APRA is proposing that the design of remuneration arrangements take account of the risks in the institution's business activities and allow time for outcomes of those business activities to be measured reliably. This means that performance-based remuneration should be 'at risk' of forfeiture until the individual's performance can be validated. This is designed to provide incentives for the executive to, at a minimum, observe good risk management practices, and ideally to act in the best interests of the company (and ultimately shareholders) over the long term.

25. One way of achieving this is to defer some or all of the allocated performance-based remuneration until the end of a deferral period, at which time an assessment can be made of whether the executive has met specified performance hurdles. Until the executive has cleared this validation period (during which shares and rights in the company issued to the executive can be 'clawed back' for underperformance), it is not certain that the executive will receive the shares.
26. The proposed limited taxation deferral arrangements outlined in this paper align with the direction taken by APRA in its consultation papers.

## **INTERNATIONAL COMPARISONS**

27. There are significant difficulties in comparing the tax treatment of employee shares or options in different jurisdictions because of different tax bases and different employee share plan structures.
28. Appendix D outlines the tax treatment of employee share ownership plans in the United States and the United Kingdom. These have been chosen because special taxing regimes for employee share schemes have been a feature of their tax systems for a considerable period.
29. In general, these jurisdictions have schemes that provide preferential tax treatment for employee share ownership schemes but have stringent reporting and other requirements.

## **SECTOR CONCERNS**

### **Submissions received to date**

30. Since the Budget announcement the Government has received written submissions from business, the tax profession and other interest groups regarding the reform of the taxation of employee share schemes.
31. The submissions have welcomed the opportunity to consult on the proposed changes.
32. Submissions have acknowledged that there are important tax integrity issues in the operation of the pre-Budget employee share scheme provisions. Additionally, many submissions have outlined concerns with the 2009 Budget changes, and made suggestions for improvement.

### **Key concerns**

33. Because submissions have not formally been called for before the release of this consultation paper, the Treasury has treated these early submissions as commercial-in-confidence, so the key concerns outlined below are not attributed to particular groups.
34. Key concerns expressed in the submissions received to date include:
  - the \$60,000 threshold is too low and will discourage participation in employee share schemes across the workforce;

- establishing whether or not an employee will have an adjusted taxable income below \$60,000 will introduce additional compliance costs for employers and employees;
- many companies operating employee share schemes do not have enough employees with adjusted taxable incomes below \$60,000 to justify the administrative costs of operating an employee share scheme that attracts the \$1,000 tax concession and is broadly available to most employees;
- the proposed changes run counter to best practice remuneration and will reduce the alignment between the interests of shareholders, executives and employees;
- the changes will encourage a shift towards greater cash remuneration and bonuses;
- the Tax Office already has sufficient administrative powers to ensure compliance with the employee share schemes rules;
- small or early-stage companies, who offer options or equity in the company to attract skilled employees in lieu of cash remuneration, will be particularly adversely affected by the proposed changes;
- securities in unlisted companies can be highly illiquid, and may never be realised;
- employees will incur an upfront tax liability in relation to benefits that have not been, and may never be, realised; and
- the announced Budget changes will significantly discourage employee share schemes.

## **Suggestions**

35. Many of the submissions have made suggestions to improve the operation of employee share schemes. These suggestions have included:
- benefits to employees should be taxed:
    - when shares and rights vest in the employee, or
    - when they are sold or otherwise disposed of;
  - the election for upfront taxation should be removed, including the \$1,000 tax exemption for broadly available schemes;
  - concessional provisions should be made for small businesses or early-stage companies;
  - tax avoidance would be better addressed through additional targeted Tax Office compliance activities and funding, than through additional legislative powers designed to improve compliance;

- reporting arrangements could be improved through:
  - tax file number (TFN) based reporting,
  - utilising the Pay-As-You-Go Withholding system, or
  - having employers report employee share scheme benefits in a similar way to fringe benefits;
- an immediate announcement should be made that no changes to the existing law will be made this financial year, to provide certainty to business; and
- any changes should be deferred to apply from 1 January or 1 July 2010 or, at the earliest, from the date of announcement of any revised changes after consultation.

## PROPOSED APPROACH FOR TAXATION OF EMPLOYEE SHARE SCHEMES

36. The arrangements announced in the 2009 Budget sought to tax all discounts on shares and rights provided under an employee share scheme in the income year in which the shares and rights are acquired.

37. As announced, the measure had the following revenue impact (\$m):

<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>	<i>Total</i>
10.0	90.0	60.0	40.0	200.0

38. Upfront taxation will remain as the Government's starting point for the taxation of employee share scheme arrangements. However, the Government will provide concessional tax treatment for particular schemes in the form of a tax exemption or tax deferral in limited circumstances.

39. Specifically, the Government proposes to modify the announced measure:

- to raise the income threshold for the \$1,000 tax exemption to \$150,000;
- to introduce a limited deferral of the taxing point for some schemes;
- to introduce an annual reporting requirement and associated withholding arrangements by companies that participate in these schemes;
- to review the existing rules for valuing discounted and deferred shares or rights; and
- to modify the rules relating to the refund of income tax for forfeited benefits.

39.1. Each of these matters is discussed below.

40. These proposed modifications deal with the compliance problems as well as the problems of excessive concessionality. Whilst the proposed reporting requirements can address some of the compliance problems, tightening of the conditions for deferral was also needed to address problems with the existing law, such as the artificial deferral of taxation.
41. A diagrammatic representation of the proposed new tax framework is at Appendix B.
42. A preliminary draft Bill implementing the Government’s proposed new framework has been included at Appendix A, for the purposes of consultation. While the consequential amendments are still being drafted, the preliminary draft bill contains most of the core rules applying under the new framework and the Government will be making further refinements to the draft before its introduction into Parliament.
43. The measure as proposed in this consultation paper is estimated to have the following revenue impact (\$m):

	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>	<i>Total</i>
Proposed measure	0	40.0	50.0	55.0	145.0
Variation to Budget measure	-10.0	-50.0	-10.0	15.0	-55.0

44. Whilst the modifications produce a smaller revenue savings over the forward estimates, the Government expects the modifications to result in additional revenue over a longer time horizon.
- 44.1. As the taxing point will continue to be deferred for some schemes, the proposed framework will forgo some revenue brought forward under the Budget measure.
- 44.2. However, the benefits from improved compliance under the proposed changes are expected to grow beyond the forward estimates period.

### Income test for the \$1,000 tax exemption

45. The Budget measure announced that the \$1,000 tax exemption would only be available to taxpayers who have an adjusted taxable income of less than \$60,000. Taxable income is adjusted to add reportable fringe benefits, reportable superannuation contributions and negative gearing losses (known as ‘net investment losses’).
46. The \$1,000 exemption is intended to apply where an employer has provided an employee with discounted shares or rights in order to align their interests.<sup>4</sup>

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<sup>4</sup> See footnote 2.

47. It has been argued that the \$60,000 threshold announced in the Budget is too low and would exclude a significant proportion of employees, making employee share schemes uneconomical to run. However, data collected by the Australian Bureau of Statistics suggests that a majority of employees now holding shares or rights under such schemes are below the \$60,000 threshold.<sup>5</sup>
- 47.1. Further, this argument seems to suggest that employers do not expect a large gain in productivity from the alignment of employer and employee interests through equity participation, at least relative to the value of the \$1,000 tax benefit.
48. For reasons of equity and fiscal sustainability, it is necessary for the Government to target its various support programs to taxpayers in particular income ranges. The Budget changes are designed to ensure that the tax concessions are targeted to promote the availability and take-up of employee share schemes among low and middle income employees.
49. Whilst it is mainly up to employers to make the schemes more attractive so as to encourage a greater take-up, the tax system has long assisted employers to provide remuneration in this form to their employees (subject to a number of conditions). The Government considers that increasing the threshold to \$150,000 (adjusted taxable income) would be more consistent with current industry practices.
- 49.1. Submissions to Government have suggested that industry generally provides for two types of qualifying schemes – those designed around the ‘upfront concession’ and the others around the ‘tax-deferred concession’. It is expected that the \$150,000 threshold should cover the vast majority of employees who currently participate in schemes designed around the \$1,000 tax exemption.
50. A key element of the existing conditions for the \$1,000 exemption is that there be no risk of forfeiture of the shares or rights. The Government proposes that this condition be maintained, along with the other conditions under the existing law for the ‘upfront concession’.<sup>6</sup>
51. The Government has also received submissions suggesting that the upfront tax exemption be abolished and that the deferral arrangements should be the only concession available, but to all employees. However, the Government considers that this would adversely affect low to middle income employees who predominantly use the upfront concession.
52. Under the existing law, employers who provide shares or rights eligible for the upfront concession can deduct up to \$1,000 in respect of each employee to whom shares or rights are provided to in that income year. This will continue to apply under the new framework, regardless of an employee’s income.

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<sup>5</sup> Australian Bureau of Statistics (2004) *Survey of Employee Earnings, Benefits and Trade Union Membership*, Cat. No. 6310.0, August 2004, Australian Government.

<sup>6</sup> See footnote 2.

53. The refined \$1,000 tax exemption and associated income test can be found in proposed Subdivision 83A-B of *Income Tax Assessment Act 1997*. See the draft law at Appendix A.

### Proposed approach

1. That the \$1,000 tax exemption be income tested.
2. That the income threshold be set at an adjusted taxable income of \$150,000.

### Deferring the taxing point

54. Under the arrangements announced in the 2009 Budget, all discounts on shares and rights provided under an employee share scheme would be assessed in the income year in which the shares and rights are acquired. The Budget measure sought to reduce the ability of taxpayers to avoid tax on their shares and rights acquired under employee share schemes and to reduce the concession provided under the existing arrangements.
- 54.1. Taxing employees on discounts at acquisition reduces the compliance risk and improves the visibility of recipients to the Tax Office.
- 54.2. The State and Territory payroll tax base includes benefits from equity-based remuneration, usually in the income year in which it is acquired, allowing deferral in situations more limited than those under income tax law.
55. Many have argued against removing the ability to defer taxation on employee share scheme shares or rights, claiming that taxing shares and rights upfront raises cash flow difficulties; potentially taxes unrealised benefits; and, depending on how schemes are structured, runs counter to the recent international moves to align executive and shareholder interests.
56. However, it has also been acknowledged that the existing tax arrangements are too concessional and have been used for tax avoidance, and that the Government should seek to address these matters. Business has provided substantial information on the potential for excessive concessionality, and alternative arrangements have been proposed which may address these issues, including for example, bringing forward the existing taxing point from exercise to vesting.
57. It is a principle of Australia's tax system that income is taxed in the year that it is earned. Consistent with this principle, upfront taxation will remain as the Government's starting point for the taxation of employee share scheme arrangements.
- 57.1. The economic value embodied in employee share scheme shares and rights is equivalent to any other form of employee compensation and should generally be taxed in the same manner. A challenge with determining the appropriate tax treatment of employee share schemes is that the economic value may accrue at a time different from when it is legally accrued. In particular, economic accrual may occur before legal accrual and that value may be accessed through the financial system. This underlies the disposition towards upfront taxation.



- 57.2. The existing law allows for the artificial deferral of taxation for extended period on what is in effect employee compensation, despite there being no risk of forfeiture in the shares or rights
58. However, the Government recognises that deferral may be the appropriate treatment in situations where there is a real risk that the benefits of shares or rights are never realised (because of forfeiture).
59. In addition to the existing conditions for deferral<sup>7</sup>, there would be a further requirement that any share or right obtained under the scheme would be subject to a genuine risk of forfeiture.
- 59.1. This requirement will distinguish deferral schemes from schemes eligible for the \$1,000 tax exemption. In the existing law, the latter schemes are already subject to a condition that the employee be subject to no risk of forfeiture.

### Removing the taxpayer's election to defer

60. As a result, whether a share or right is subject to taxation (upfront or at a later time) will depend on the structure of the scheme and not an election of the taxpayer. This should eliminate the compliance problems associated with the existing election arrangements.
- 60.1. Removing the election for employees will also make it easier for employers to comply with the proposed reporting arrangements (see later) and for the Tax Office to monitor the new arrangements.
- 60.2. Schemes that do not comply with the conditions for these limited deferral arrangements will be subject to upfront taxation consistent with the Budget announcement. The income tested \$1,000 tax exemption will be available to those schemes (subject to meeting the relevant conditions).

### Genuine risk of forfeiture

61. The Government considers that genuine risk of forfeiture covers those cases where there is a risk that the employee might never get full title to the share or right.
- 61.1. The risk must be a real risk – contrived schemes, where the risk is highly unlikely to arise, will not qualify (for example, ‘your shares are forfeited if the company’s value falls by 95 per cent during the next 12 months’ and ‘your shares are forfeited if you request they be forfeited’).<sup>8</sup> The concept is similar to that of ‘effectively non-contingent obligation’ in the *Income Tax Assessment Act 1997*.

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<sup>7</sup> See footnote 1.

<sup>8</sup> For example, an audit identified a taxpayer who reported a condition that shares are forfeited ‘if the sun does not rise tomorrow’. This was considered a contrived scheme which sought to introduce a sham risk of forfeiture in order to qualify for deferral of the taxing point.



- 61.2. A genuine risk includes situations in which a share or right is subject to meaningful performance hurdles or there is a requirement to serve a minimum term of employment. However, a condition that merely restricts an employee from disposing of a share or right for a specified time carries with it no genuine risk of forfeiture.
- 61.3. A meaningful performance hurdle is one that is imposed for the purpose of achieving future goals. Performance hurdles that have been met at the time they are imposed will not suffice.
- 61.4. A test to be applied in determining whether there is a genuine risk of forfeiture will be an objective one. That is, would a reasonable person conclude that there is a real risk that the share or right may not vest or may be forfeited.

### **Deferred taxing points**

62. The Government also considers that the current timing of the taxing point or deferral needs to be modified to limit the compliance risk and reduce the concessionality of the existing arrangements.
63. The Government proposes that the taxing point ('deferred taxing point') for shares or stapled securities should be the earliest of:
- the first time that the employee (or their associate) is able to take the steps necessary to pass immediate legal and beneficial title in the share or stapled security (or would be but for a restriction that the share not be disposed of before a specified future time) – that is, a point at which the taxpayer will no longer have a real risk of losing the share;
  - when the employee ceases the employment in respect of which they (or their associate) acquired the share or stapled security; or
  - 7 years after the employee (or their associate) acquired the share or stapled security.
64. The Government proposes that the taxing point ('deferred taxing point') for rights should be the earliest of:
- the first time that the employee (or their associate) is able to take the steps necessary to exercise, or to pass immediate title in, the right (or would be but for a restriction that the right not be exercised or disposed of before a specified future time) – that is, a point at which the taxpayer will no longer have a real risk of not being able to exercise the share;
  - when the employee ceases the employment in respect of which they (or their associate) acquired the right; or
  - 7 years after the employee (or their associate) acquired the right.

65. The Government's proposed approach shortens the maximum time period from 10 years under the existing law to 7 years, to align with industry practice. This will reduce the potential tax concession available under the deferral arrangement. Further, a time-limited taxing point is necessary simply to ensure that shares or rights do in fact vest in a reasonable period.
66. The proposed limited taxation deferral arrangement – whereby an employee's tax obligation is deferred where there is a genuine risk of forfeiture of the shares or rights – is consistent with the direction taken by APRA in its consultation paper.

### Taxing point on ceasing employment

67. For prudentially regulated institutions under APRA's supervision, APRA would prefer that cessation of employment not trigger the complete vesting of shares in the departing employee. This is intended to better align the interests of the employee with the longer-term performance of the institution.
  - 67.1. However, it will be open to institutions under APRA's supervision to structure their affairs to meet both tax and prudential policy objectives. APRA's draft Prudential Practice Guide suggests that "...an institution may permit the partial vesting of an amount to cover taxation obligations of the employee arising from the deferred component." The Government believes that this is an appropriate mechanism to ensure that tax can be paid on cessation of employment without requiring all shares or rights to vest.
68. Ceasing employment is a deferred taxing point under the current tax law. Considerable tax integrity issues would arise if it is removed as a taxing point because, amongst other things, employees may move overseas after ceasing employment making it difficult for the Tax Office to collect any tax.
  - 68.1. For tax purposes, the Government therefore proposes to keep the existing employment-related deferred taxing point.
  - 68.2. This arrangement will also not prevent the remaining shares or rights from being subject to a genuine risk of forfeiture.
    - 68.2.1. Further, in situations where the tax is paid and shares are subsequently genuinely forfeited, a tax refund is available.
69. The limited deferral scheme can be found in proposed Subdivision 83A-C of the *Income Tax Assessment Act 1997*. See the draft law at Appendix A.

### Proposed approach

1. That the general approach continues as announced in the Budget (i.e., tax on the discount upfront).
2. That a limited deferral arrangement be reintroduced.
3. That deferral should be limited to schemes meeting the qualifying conditions for deferral under the existing law with an additional requirement that any shares or rights obtained under the scheme be subject to a genuine risk of forfeiture.
4. That deferral treatment will flow from the structure of the scheme rather than the (non) exercise of an election by the taxpayer.
5. That existing taxing points under the deferred arrangements be modified to limit maximum deferral until the end of 7 years (disregarding any waiting period), cessation of employment or when the employee can pass title to the share or right.

### Reporting requirements for employers

70. As noted above, the Budget measure was designed to protect losses to Commonwealth revenue through evasion, avoidance or confusion as to the taxpayer's obligations.
71. It has been suggested that the Government introduce a requirement for employers to provide employee share scheme information to the Tax Office. This would enable data-matching to reduce the current levels of both intentional and unintentional non-compliance. This would take employee share schemes out of the audit space and into the standard periodic operation of the taxation system.
72. When deciding whether to introduce any new reporting requirements the Government will need to balance the increased compliance against the increased compliance costs for businesses offering employee share scheme arrangements. In this case, organisations that made early submissions have indicated that any additional compliance costs are likely to be low.
73. The Government therefore proposes that reporting requirements be introduced for employers offering employee share schemes (including those schemes not qualifying for concessional tax treatment).
  - 73.1. Employers who have provided shares, stapled securities or rights under an employee share scheme must give the Tax Office a statement each financial year covering each affected employee. The statement must include the following information:
    - the employee's name, address, and tax file number (TFN) or Australian business number (ABN) (if known);
    - the numbers of shares, stapled securities and rights acquired by the employee under the employee share scheme in the financial year;

- the employer's estimate of the total market values of those shares, stapled securities and rights when the employee acquired them<sup>9</sup>;
- the numbers of shares, stapled securities and rights which in the financial year were subject to a deferred taxing point (as described in paragraphs 63 and 64);
- the employer's estimate of the total market values of those shares, stapled securities and rights when they were subject to a deferred taxing point;
- the total amount the employee has provided from after-tax income, at or before the deferred taxing point, towards acquiring those shares, stapled securities and rights; and
- the amounts paid to the Tax Office because the employee did not provide a TFN or ABN (see withholding arrangements below).

73.2. Consistent with an employer's obligations under the Pay-As-You-Go Withholding system, the statement must be in the form approved by the Tax Office (approved form) and must be provided by 14 August following the end of the financial year.

73.2.1. The general rules governing approved forms<sup>10</sup> will allow the Tax Office to expand on the information that the statement must contain, so that the Tax Office will have all the necessary information to ensure compliance with the new arrangements. The additional information may include matters such as the type of scheme the securities relate to and the expected time of the deferred taxing point.

73.2.2. The Tax Office will undertake further consultation on the development of new forms with employers and tax professionals.

73.2.3. In the longer term, the Tax Office may be able to utilise this information to assist employees with their tax obligations by pre-filling tax returns.

73.3. By 14 July following the end of the financial year, the employer must provide each affected employee with a statement containing the above information relevant to that employee. The timing of this obligation is consistent with an employer's obligation to provide each employee with a Pay-As-You-Go payment summary.

73.4. The Tax Office will settle details of the approved form for reporting the methods of reporting before the first reports fall due.

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<sup>9</sup> The references to estimates in the new statements are to protect employers if they have to work out the market value of something which can only be estimated.

<sup>10</sup> The approved form rules are set out in Division 388 in Schedule 1 to the *Taxation Administration Act 1953*.

74. The main purpose of these reporting requirements is to address the concern raised by the Tax Office that the current employee share scheme rules are not being complied with and that the Tax Office is not in a position to know the full extent of that non-compliance.
75. The proposed new reporting regime is contained in proposed Division 392 in Schedule 1 to the *Taxation Administration Act 1953*. See the draft law at Appendix A.

### Proposed approach

1. That a new annual reporting requirement be introduced for employers offering employee share schemes.

### Withholding arrangements

76. Also in response to the identified compliance problems with the existing law, it has been suggested that the Government extend the general employer withholding arrangements to shares, stapled securities and rights issued under employee share schemes.
  - 76.1. The suggestions received by the Government are wide ranging. Some argue for a withholding system that would require the employer to withhold in all cases where an employee acquires a share, stapled security or right (or where one is subject to a deferred taxing point). This would require withholding from other salary or wage income or the forced sale of some or all of the securities by the employer.
  - 76.2. Others argue for a more limited withholding, such as in cases where employees refuse to provide a TFN.
77. Applying withholding arrangements to non-cash benefits raises both legal and practical difficulties, since there is no payment from which to withhold. The Pay-As-You-Go Withholding system currently contains rules for such cases, but these apply in only very limited situations. Applying them more broadly would likely result in high compliance costs and administrative difficulties for the employer, employee and the Tax Office.
78. However, the Government acknowledges that the case for withholding is stronger where an employee refuses to provide their employer with a TFN or ABN (as the case requires) since this undermines the proposed reporting regime.
79. It is rare for an employee to refuse to provide their employer with a TFN, so limiting withholding to those cases is unlikely to result in an increase in compliance costs for employers.
80. The Government therefore proposes that a limited form of withholding be introduced in cases where an employee refuses to provide their employer with a TFN.
  - 80.1. If the employee does not provide a TFN then the employer must pay an amount to the Tax Office in relation to an employee who is taxable on either acquiring a security or where a security is subject to a deferred taxing point.

- 80.2. Consistent with the other no-TFN withholding rules, the amount withheld will be at the top marginal rate plus Medicare Levy. The rate will be applied to the amount that the employee is required to include in their assessable income (ignoring the possible application of the \$1,000 tax exemption).
- 80.2.1. It is necessary to ignore the \$1,000 tax exemption as employers will not be in a position to know the adjusted taxable income of an employee.
- 80.3. Consistent with the current Pay-As-You-Go Withholding machinery rules:
- the employer must provide the employee with written notice of each amount paid to the Tax Office;
  - the employee will be entitled to a credit in their tax return for the amount paid by the employer;
  - the employee will be entitled to recover from the employer or the Tax Office any amounts paid by the employer in error; and
  - the employer can recover from the employee, as a debt, the amount paid to the Tax Office on their behalf.
81. This limited withholding arrangement should ensure the integrity of the new reporting arrangements whilst minimising any compliance costs for employers.
82. The proposed new reporting regime is contained in proposed new Subdivision 14-C in Schedule 1 to the *Taxation Administration Act 1953*. See the draft law at Appendix A. For constitutional reasons, an imposition Act may also be required but has not yet been drafted.

### Proposed approach

1. That a limited form of withholding be introduced in cases where an employee fails to provide their employer with a TFN or ABN.

### Valuation issues

83. The Treasurer and the Assistant Treasurer announced in their media release of 24 May 2009 that the Government would canvass options on whether the tax law provisions which determine the market value of shares or rights result in undervaluation.
84. The accounting treatment of share-based payments, summarised at Appendix E, seeks to provide a true and fair view of the company accounts and provides for valuation rules based on principles. These are not currently consistent with the rules in the tax law.

### Taxation requirements for valuation

85. Under the existing employee share scheme rules, the market value of a share, right or stapled security is determined in accordance with Subdivision F of Division 13A of Part III of the ITAA 1936.

- 85.1. Those rules basically mirror the ordinary meaning of 'market value' except in respect of unlisted rights, where elaborate formulas and tables are provided as a proxy for market value.
86. Valuation can be difficult where the share or right is not listed on a stock exchange. The alternative valuation methods used in the existing law for unlisted rights tend to lead to under-valuation.
87. Many provisions of the tax laws require a market value to be determined. The Tax Office has published a guide<sup>11</sup> to help taxpayers and their advisers (including valuers) establish a market value for taxation purposes.
- 87.1. Employers can request the Tax Office for a binding private ruling on a valuation matter.
88. These accepted principles of valuation are outlined in the Tax Office's guide. While the process of valuing a thing can range from being simple to complex, the principles remain constant. Some common instances of where the tax law requires valuation are:
- for individuals – transfers of real estate or shares between related parties, such as husband and wife, or family members;
  - for employees – non-cash benefit transactions, such as gifts, or other benefits, such as car parking;
  - for small businesses – transfers of assets to related parties, or passing the asset threshold tests for the small business capital gains tax concessions;
  - for medium and large businesses – consolidation events; and
  - for all taxpayers – many anti-avoidance provisions.
89. Although the law frequently refers to market value, the meaning of that term will depend on its statutory context.
90. Current tax law does not define market value in any general provision. As a result, 'market value' takes the ordinary meaning discussed below, unless specially defined or qualified in a particular provision.
91. The High Court of Australia has recognised<sup>12</sup> the principles guiding the meaning of 'market value' as:
- the willing but not anxious buyer and seller;
  - a hypothetical market;

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<sup>11</sup> Australian Taxation Office, *Market Valuation for Tax Purposes* (available online at <http://www.ato.gov.au>).

<sup>12</sup> *Spencer v The Commonwealth of Australia* (1907) 5 CLR 418.



- the parties being fully informed of the advantages and disadvantages associated with the asset being valued; and
  - both parties being aware of current market conditions.
92. However, the tax law qualifies the ordinary meaning of market value established by the High Court. For instance, under Subdivision 960-S of the ITAA 1997:
- the market value of an asset is reduced by the amount of GST credits, to the extent that such credits relate to a taxable supply; and
  - anything restricting or preventing the conversion of non-cash benefits (that is, property or services in any form except money) into money is disregarded in determining the market value of non-cash benefits.
93. The Government's preferred in principle approach to determining market value is not to include a formulaic substitute for market value, but to leave the matter for the Tax Office, in consultation with taxpayers and tax advisers, to rule on and to provide necessary guidance using the general principles of determining market value subject to normal review processes. As noted above, this has been longstanding practice in other areas of the tax law.
94. The 2000 inquiry by the House of Representatives Standing Committee on Employment, Education and Workplace Relations into employee share ownership in Australian enterprises noted that 'the method of valuing shares and options in Division 13A employee share plans attracted considerable criticism from witnesses'. The Committee also stated that:
- ...a process for valuing shares, or options when issued, should be developed that addresses these problems as well as the more general issues of taxation compliance and corporate governance. The present process, at a minimum, should be revised and articulated clearly. However, the valuation method should also protect the viability of companies and the revenue base against exploitation.*
95. The Committee recommended:
- that the Government direct the Tax Office and the Australian Securities and Investment Commission, in consultation with interested stakeholders, to develop appropriate and simplified valuation processes;
  - that the anomalies and uncertainties in the present valuation system be addressed and, where possible, removed; and
  - that model plans should be devised by the Tax Office, in consultation with stakeholders, and that these model plans specify appropriate, simplified and Tax Office-endorsed valuation processes.
96. The former Government did not accept the Committee's recommendation.



## Consideration of the issues

97. It has been observed that in areas where valuation is difficult, there is a great pressure for 'rules of thumb' to provide certainty. However, these rules of thumb tend to lead to under-taxation. That has been recognised to be the case with the existing employee share scheme valuation arrangements for unlisted rights. One academic has remarked that the valuation rules in Division 13A "could not possibly be derived from an application of the Black-Scholes model or any other option pricing model (in which the volatility of the share price is an important factor)".<sup>13</sup>
98. It has also been recognised that many of the existing option pricing models do not take account of situations in which parties are not dealing with one another entirely at arm's length. That is to say, many employers may provide an element of remuneration within the pricing of their employee share arrangements that is not taken account of in the assumptions underpinning many of the option pricing models.
99. The Government remains concerned that the current valuation rules for unlisted rights under employee share schemes have resulted in a systematic undervaluation and therefore, frequent under-taxation. The Government is also concerned about the issues raised by the House of Representatives' Standing Committee in 2000.
100. However, the Government understands the call for immediate certainty in respect of employee share scheme arrangements, particularly given the high volume of employee share scheme transactions.
101. The Government therefore proposes that under the new framework, the general principle of market value should apply in determining the market value of a listed and unlisted security in the first instance. However, the new framework will allow the Government to provide for a 'rule-of-thumb' in regulations. As an interim measure, the Government proposes to replicate in the regulations the existing valuation rules for unlisted rights.
102. This approach will allow the Government to review these valuation rules thoroughly and consider whether they should be retained or modified. The Government will also refer the valuation issues to the Board of Taxation for advice.
103. The valuation rules can be found in proposed Division 83A of *Income Tax Assessment Act 1997*. See the draft law at Appendix A. The proposed regulations are still to be drafted but will reproduce the existing valuation rules in sections 139FC to 139FN.

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<sup>13</sup> Sandler, D, "The Tax Treatment of Employee Stock Options: Generous to a Fault" (2001) vol. 49, no. 2 *Canadian Tax Journal* 259-319 (available online at [http://www.ctf.ca/pdf/ctjpdf/2001ctj2\\_sandler.pdf](http://www.ctf.ca/pdf/ctjpdf/2001ctj2_sandler.pdf)).

### Proposed approach

1. That the general principles of market value should apply in determining the market value of listed and unlisted securities.
2. That the new framework allows for regulations to provide for a 'rule-of-thumb' where necessary.
3. That as an interim measure the existing valuation rules for unlisted rights be replicated in the regulations.
4. That the valuation rules be reviewed.

### Need for Tax Office approval for employee share schemes to qualify for tax concessions

104. In response to identified compliance problems, submissions to the Government have suggested that for employee share schemes to qualify for concessional tax treatment they should be subject to approval by the Tax Office.

104.1. Alternatively, for schemes offered by prudentially regulated entities, that APRA be required to approve the scheme.

105. The Government understands that an approval process operates in the United Kingdom and that HM Revenue and Customs also has the ability to revoke approval if schemes later fail to comply with stipulated requirements or involve an element of tax avoidance or evasion.

106. Such a process, while attractive from a revenue protection point-of-view, would consume significant Tax Office/APRA resources, and would likely delay significantly the time it takes to bring a scheme into operation.

107. For this reason, the Government does not support such a process being introduced in Australia. The Government believes that the additional changes it is proposing will be sufficient to rectify existing compliance problems.

107.1. The class rulings system is available to employers wanting greater certainty about how the tax law applies to their particular employee share scheme.

107.2. If compliance problems persist after the new arrangements come into operation, this issue could be reconsidered.

### Proposed approach

1. That employee share schemes should not have to be approved by the Tax Office or APRA to qualify for concessional tax treatment.

## **Refund of income tax for forfeited benefits**

108. Under the existing rules, a right to acquire a share or right in a company is treated as never having been acquired if the taxpayer loses the right without having exercised it. This allows a taxpayer to claim a refund of income tax for rights that have been subject to tax on acquisition, but have lapsed without the taxpayer exercising them.
- 108.1. There is no time limit on amending an assessment to exclude an amount from a taxpayer's assessable income for a right which was lost without being exercised.
- 108.2. In the absence of the refund rules, the taxpayer would instead have a capital loss under the CGT provisions.
109. It has been strongly argued that the current rules for refunding income tax on forfeited rights are too wide in some respects but too narrow in others.
- 109.1. It has been argued that a refund remains appropriate in a case where the taxpayer has failed to meet the necessary performance hurdles in order to exercise the right. This is considered the paradigm case of forfeited benefits and the original focus of the existing rules.
- 109.2. Conversely, it is argued that if a taxpayer meets all the performance requirements necessary to exercise the right but chooses not to do so because of an adverse change in market conditions, a refund is inappropriate. In substance, the revenue is protecting the taxpayer from downside market risk. In this case the benefits have not been truly forfeited but have instead been relinquished by the taxpayer because their value has fallen.
- 109.3. It has also been argued that the refund rules should be widened to cover shares that have been forfeited because of a condition subsequent relating, for example, to performance hurdles.
110. The Government considers that in upfront taxation cases, a taxpayer should continue to be treated as having never acquired a right that never vests, or is extinguished or forfeited without the taxpayer having either exercised or transferred it.
- 110.1. Similarly, a taxpayer should be treated as never having acquired a share if the taxpayer's interest in it is later forfeited or if the share will never vest. For the share forfeiture case to apply, the share must have been 'acquired' in some sense (at least a beneficial interest) before anything would be assessed, so the forfeiture cases would have to involve a loss of that interest. Whilst these cases are likely to be rare, they can exist and need to be addressed.
- 110.2. There should continue to be no time limit for amending an assessment to give effect to this result.
111. The Government proposes that the refund rules should not apply if the extinguishment, forfeiture or inability to vest occurs as the result of a choice the taxpayer makes (including choosing not to exercise a right).

- 111.1. In such a case the refund rules could be exploited to subsidise commercial losses. For example, payment for an option might be deferred, or occur in a lengthy series of payments. If employees have a right to forfeit the option and avoid any (future) payment, they might elect to do so if its value drops. Because the Government does not want to provide a subsidy for a commercial loss, it proposes to deny any tax refund where the employee chooses that the share or right be extinguished, forfeited or not vest.
- 111.2. Of course, such a result could be contrived without the employee having to make an explicit choice. For instance, the employee share scheme could provide for automatic forfeiture if the value of the company's shares fell below some set level. The Government would also want to deny a refund in those cases because, in effect, they represent the employee making a conditional choice in advance.
112. Further, the Government proposes to extend the refund rules to cover shares which have been forfeited because of a condition subsequent.
113. The rules relating to the refund of income tax for forfeited benefits can be found in proposed section 83A-310 of *Income Tax Assessment Act 1997*. See the draft law at Appendix A.

#### Proposed approach

1. That the refund rules be extended to cover forfeited shares.
2. That the refund rules should not apply if the extinguishment, forfeiture or inability to vest occurs as the result of a choice the taxpayer makes (including choosing not to exercise a right).
2. That appropriate rules be put in place to prevent contrived situations.

#### Need for specific anti-avoidance rules / additional penalties

114. There have been a number of proposals for additional anti-avoidance rules or penalties to deal with identified compliance problems with the existing employee share scheme arrangements.
- 114.1. A number of people have suggested that the penalties for non-compliance be increased and that new anti-avoidance rules be introduced to prevent taxpayers from using employee share schemes as a means of tax avoidance.
- 114.2. The Government is concerned about schemes that extend deferral periods or that convert income into more concessionally taxed capital gains.
115. At this time the Government's view is that on balance, the proposed approach (outlined above) should be adequate and that new specific anti-avoidance rules, beyond the general anti-avoidance provisions, are not required.
- 115.1. However, the Government will reconsider this if schemes are entered into that seek to avoid the intended operation of the new framework.

115.2. The Assistant Treasurer announced in the 2009 Budget that the Government will shortly release a discussion paper canvassing options to consolidate, streamline and improve the operation of provisions designed to counter tax avoidance.

116. The Government does not propose at this time to introduce new penalties for non-compliance with the employee share scheme rules, as the existing uniform penalty regime should apply appropriately. The proposed new reporting regime should also minimise opportunities for tax avoidance and assist in identifying those taxpayers that engage in non-compliance.

### **Proposed approach**

1. That no new specific anti-avoidance rules or penalties be introduced at this time.

### **Comments on draft Bill**

117. A preliminary draft Bill implementing the Government's proposed new framework has been included at Appendix A, for the purposes of consultation. While the consequential amendments are still being drafted, the preliminary draft bill contains most of the core rules applying under the new framework and the Government will be making further refinements to the draft before its introduction into Parliament.

118. Given the concerns with the complexity and readability of Division 13A, the draft Bill rewrites the rules into the ITAA 1997. This provides the opportunity to simplify the style and expression of the law and to restructure it. These changes are aimed at reducing complexity and assisting taxpayers and their advisers comply with the new arrangements.

119. The draft also makes some improvements to the way the eligibility criteria for the tax concessions are expressed.

120. Treasury is seeking feedback on the draft law.

### **Consultation questions**

1. Does the law properly give effect to Government's position as outlined in this consultation paper?

2. Do you have further suggestions for improving the expression of the eligibility criteria?

### **Commencement time for the changes**

121. The Government announced in the 2009 Budget that new rules would affect shares and rights acquired from 7:30pm on 12 May 2009.

122. However, the Government understands the call for immediate certainty in respect of the new framework and recognises that many schemes have been suspended until further details are clarified.

- 122.1. Submissions have sought reinstatement of the existing arrangements pending release of the Government's final position.
- 122.2. This consultation paper seeks to provide the additional details that have been sought.
123. The new proposed reporting regime will require system changes for both the Tax Office and employers offering employee share schemes. For that reason, the Government has determined that it will not implement a new reporting regime before the 2009-10 financial year.
- 123.1. However, the Tax Office could use its existing information collection powers to collect the relevant information in respect of current and prior income years.
124. Consequently, the Government proposes that the new arrangements commence on 1 July 2009. That is, the new framework will apply to shares or rights acquired on or after 1 July 2009.
- 124.1. In the interim, the existing law will apply to all shares and rights acquired before 1 July 2009.
- 124.2. In order to mitigate integrity problems in the existing law, the Tax Office will use its current information collection powers to investigate existing schemes as part of a broad compliance program.
- 124.3. The Government will closely monitor taxpayers' compliance with the new regime for evidence of continued tax avoidance and if necessary will introduce further changes to close off such activity.

### **Proposed approach**

1. That the new arrangements apply to shares or rights acquired on or after 1 July 2009.
2. That in the interim, the existing law apply to all shares and rights acquired before 1 July 2009.

## APPENDIX A – DRAFT LAW

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1 Inserts for  
2 **Tax Laws Amendment (Employee share**  
3 **schemes) Bill 2009**  
4  
5 **Schedule ESS—Employee share schemes**  
6

7 *Income Tax Assessment Act 1997*

8 **1 At the end of Part 2-40**

9 Add:

10 **Division 83A—Employee share schemes**

11 **Table of Subdivisions**

12	Guide to Division 83A
13	83A-A Objects and application of Division
14	83A-B Immediate inclusion of discount in assessable income
15	83A-C Deferred inclusion of gain in assessable income
16	83A-D Deduction for employer
17	83A-E Miscellaneous

18 **Guide to Division 83A**

19 **@83A-1 What this Division is about**

20 [to be completed].

21 **Subdivision 83A-A—Objects and application of Division**

22 **Table of sections**

23 @83A-10 Objects of Division

24 **@83A-10 Objects of Division**

25 The objects of this Division are:



- 
- 1 (a) to ensure that benefits provided under \*employee share  
2 schemes are subject to income tax at the employees' marginal  
3 rates under \*income tax law (instead of being subject to  
4 \*fringe benefits tax law); and  
5 (b) to increase the extent to which the interests of employees are  
6 aligned with those of their employer, by providing a tax  
7 concession to encourage lower and middle income earners to  
8 acquire \*shares under such schemes.

9 **Subdivision 83A-B—Immediate inclusion of discount in**  
10 **assessable income**

11 **Table of sections**

- 12 @83A-15 Discount to be included in assessable income  
13 @83A-20 Amount for which discounted share or right acquired  
14 @83A-25 Reduction of amounts included in assessable income

15 **@83A-15 Discount to be included in assessable income**

- 16 (1) Your assessable income for an income year in which you \*acquire  
17 a \*share in a company, or a right to acquire a share in a company,  
18 under an \*employee share scheme includes the discount (if any)  
19 given in relation to the share or right.

20 Note: This Subdivision does not apply if Subdivision 83A-C applies: see  
21 section @83A-100.

- 22 (2) Treat an amount included in your assessable income under  
23 subsection (1) as being from a source other than an \*Australian  
24 source to the extent that it relates to your employment outside  
25 Australia.
- 26 (3) Subsection (1) does not apply to an \*acquisition of a \*share under  
27 an \*employee share scheme as the result of exercising a right  
28 acquired under the scheme.

29 **@83A-20 Amount for which discounted share or right acquired**

30 For the purposes of this Act (other than this Division), if there is a  
31 discount given in relation to the \*share or right, the amount for  
32 which you \*acquired the share or right is taken to be:

- 33 (a) its \*market value; or  
34 (b) if the regulations specify an amount for the purposes of this  
35 section—that amount.
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1 **@83A-25 Reduction of amounts included in assessable income**

- 2 (1) Reduce the total amount included in your assessable income for an  
3 income year under subsection @83A-15(1) for the \*shares (if any)  
4 and rights (if any) covered by subsection (2) by \$1,000 (but not  
5 below nil).
- 6 (2) This subsection covers a \*share in a company or a right to acquire a  
7 share in a company if:
- 8 (a) the sum of the following equals or falls short of \$150,000:  
9 (i) your taxable income for the income year;  
10 (ii) your \*reportable fringe benefits total (if any) for the  
11 income year;  
12 (iii) your \*reportable superannuation contributions for the  
13 income year;  
14 (iv) your \*total net investment loss for the income year; and
- 15 (b) the company is your employer or a holding company (within  
16 the meaning of the *Corporations Act 2001*) of your employer;  
17 and
- 18 (c) immediately after the \*acquisition of the share or right:  
19 (i) you do not hold a legal or beneficial interest in more  
20 than 5% of the shares in the company; and  
21 (ii) you are not in a position to cast, or control the casting  
22 of, more than 5% of the maximum number of votes that  
23 might be cast at a general meeting of the company; and
- 24 (d) there is:  
25 (i) no real risk under the conditions of the \*employee share  
26 scheme that you will never be able to control the  
27 circumstances in which the legal and beneficial interest  
28 in the share or right will be disposed of; and  
29 (ii) in the case of a right—no real risk under the conditions  
30 of the employee share scheme that you will never be  
31 able to exercise the right; and
- 32 (e) the employee share scheme was operated so that no recipient  
33 would be permitted to dispose of a share or right (the *scheme*  
34 *share* or *scheme right*) acquired under it, or of a share  
35 acquired as a result of a scheme right, before the earlier of the  
36 following times:  
37 (i) the end of the period of 3 years after the time of the  
38 acquisition of the scheme share or scheme right;  
39 (ii) the time when the relevant employee ceased to be  
40 employed by the employer; and
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- 1 (f) all the shares available for acquisition under the employee  
 2 share scheme are ordinary shares and all the rights available  
 3 for acquisition under the scheme are rights to acquire  
 4 ordinary shares; and
- 5 (g) both the employee share scheme and any scheme for the  
 6 provision of financial assistance in respect of acquisitions of  
 7 shares or rights under the employee share scheme are  
 8 operated on a non-discriminatory basis in relation to at least  
 9 75% of the permanent employees of the employer; and
- 10 (h) subsection (3) does not apply.
- 11 (3) This subsection applies if:
- 12 (a) the predominant business of the company (whether or not  
 13 stated in its constituent documents) is the \*acquisition, sale or  
 14 holding of \*shares, securities or other investments (whether  
 15 directly or indirectly through one or more companies,  
 16 partnerships or trusts); and
- 17 (b) you are employed by the company; and
- 18 (c) you are also employed by another company that is:
- 19 (i) a \*subsidiary of the first company; or
- 20 (ii) a holding company (within the meaning of the  
 21 *Corporations Act 2001*) of the first company; or
- 22 (iii) a \*subsidiary of a third company that is a holding  
 23 company (within the meaning of the *Corporations Act*  
 24 *2001*) of the first company.

25 **Subdivision 83A-C—Deferred inclusion of gain in assessable**  
 26 **income**

27 **Table of sections**

28 **Main provisions**

29 @83A-100	Application of Subdivision
30 @83A-105	Amount to be included in assessable income
31 @83A-110	ESS deferred taxing point
32 @83A-115	Re-acquisition of share or right

33 **Takeovers and restructures**

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1 **Main provisions**

2 **@83A-100 Application of Subdivision**

- 3 (1) This Subdivision applies, and Subdivision 83A-B does not apply,  
4 in relation to a \*share in a company, or a right to \*acquire a share in  
5 a company, if:
- 6 (a) you have acquired the share or right under an \*employee  
7 share scheme; and
  - 8 (b) the acquisition was not the result of exercising a right  
9 acquired under the scheme; and
  - 10 (c) there was a discount given in relation to the share or right;  
11 and
  - 12 (d) all the shares available for acquisition under the scheme are  
13 ordinary shares and all the rights available for acquisition  
14 under the scheme are rights to acquire ordinary shares; and
  - 15 (e) there is:
    - 16 (i) a real risk under the conditions of the employee share  
17 scheme that you will never be able to control the  
18 circumstances in which the legal and beneficial interest  
19 in the share or right will be disposed of; or
    - 20 (ii) in the case of a right—a real risk under the conditions of  
21 the employee share scheme that you will never be able  
22 to exercise the right; and
  - 23 (f) the company is your employer or a holding company (within  
24 the meaning of the *Corporations Act 2001*) of your employer;  
25 and
  - 26 (g) in the case of a share—at the time the share was acquired, at  
27 least 75% of the permanent employees of your employer  
28 were, or at some earlier time had been, entitled to acquire:
    - 29 (i) shares or rights under the scheme; or
    - 30 (ii) shares or rights in your employer, or a holding company  
31 (within the meaning of the *Corporations Act 2001*) of  
32 your employer, under another employee share scheme;  
33 and
  - 34 (h) immediately after the acquisition of the share or right:
    - 35 (i) you do not hold a legal or beneficial interest in more  
36 than 5% of the shares in the company; and
    - 37 (ii) you are not in a position to cast, or control the casting  
38 of, more than 5% of the maximum number of votes that  
39 might be cast at a general meeting of the company; and
  - 40 (i) subsection (2) does not apply.
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- 1 (2) This subsection applies if:
- 2 (a) the predominant business of the company (whether or not
- 3 stated in its constituent documents) is the \*acquisition, sale or
- 4 holding of \*shares, securities or other investments (whether
- 5 directly or indirectly through one or more companies,
- 6 partnerships or trusts); and
- 7 (b) you are employed by the company; and
- 8 (c) you are also employed by another company that is:
- 9 (i) a \*subsidiary of the first company; or
- 10 (ii) a holding company (within the meaning of the
- 11 *Corporations Act 2001*) of the first company; or
- 12 (iii) a \*subsidiary of a third company that is a holding
- 13 company (within the meaning of the *Corporations Act*
- 14 *2001*) of the first company.

15 **@83A-105 Amount to be included in assessable income**

- 16 (1) Your assessable income for the income year in which the \*ESS
- 17 deferred taxing point for the \*share or right (see section
- 18 @83A-110) occurs includes the amount worked out under
- 19 subsection (3).
- 20 (2) Treat an amount included in your assessable income under
- 21 subsection (1) as being from a source other than an \*Australian
- 22 source to the extent that it relates to your employment outside
- 23 Australia.
- 24 (3) The amount is the \*market value of the \*share or right at the \*ESS
- 25 deferred taxing point, reduced by the amount of any consideration
- 26 paid or given by you for the acquisition of the share or right.
- 27 (4) If the regulations specify an amount for the purposes of this
- 28 subsection, treat that amount as the \*market value of the \*share or
- 29 right for the purposes of subsection (3).

30 **@83A-110 ESS deferred taxing point**

31 *Shares*

- 32 (1) The *ESS deferred taxing point* for a \*share is the earliest of the
- 33 following:
- 34 (a) the time when there is no real risk under the conditions of the
- 35 \*employee share scheme that you will never be able to

- 
- 1 control the circumstances in which the legal and beneficial  
2 interest in the share will be disposed of;
- 3 (b) the time when the employment in respect of which the share  
4 was \*acquired ceases;
- 5 (c) the end of the 7 year period starting when you acquired the  
6 share.

7 *Rights*

- 8 (2) The *ESS deferred taxing point* for a right is the earliest of the  
9 following:
- 10 (a) the time when there is:
- 11 (i) no real risk under the conditions of the \*employee share  
12 scheme that you will never be able to control the  
13 circumstances in which the legal and beneficial interest  
14 in the right will be disposed of; and
- 15 (ii) no real risk under the conditions of the employee share  
16 scheme that you will never be able to exercise the right;
- 17 (b) the time when you dispose of the right (other than by  
18 exercising it);
- 19 (c) the time when the employment in respect of which the right  
20 was \*acquired ceases;
- 21 (d) the end of the 7 year period starting when you acquired the  
22 right.

23 **@83A-115 Re-acquisition of share or right**

24 For the purposes of this Act (other than this Division), you are  
25 taken to have \*acquired the \*share or right immediately after the  
26 \*ESS deferred taxing point for the share or right for:

- 27 (a) its \*market value; or
- 28 (b) if the regulations specify an amount for the purposes of this  
29 section—that amount.

30 **Takeovers and restructures**

31 *[to be completed later]*

32 **Subdivision 83A-D—Deduction for employer**

33 **Table of sections**

34 @83A-200 Deduction for employer

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1 **@83A-200 Deduction for employer**

- 2 (1) You can deduct an amount for an income year if:
- 3 (a) you provided one or more \*shares or rights to a person in the  
4 income year; and
- 5 (b) you did so as the employer of the person; and
- 6 (c) as a result, the person \*acquired the shares or rights under an  
7 \*employee share scheme; and
- 8 (d) section @83A-25 applies to reduce the amount included in  
9 the person's assessable income under subsection  
10 @83A-15(1) in relation to some or all of the shares or rights.
- 11 (2) Disregard paragraph @83A-25(2)(a) (income level) for the  
12 purposes of paragraph (1)(d) of this section.
- 13 (3) The amount of the deduction is the amount of the reduction  
14 mentioned in paragraph (1)(d).

15 **Subdivision 83A-E—Miscellaneous**

16 **Table of sections**

17 @83A-300	Acquiring a share or right under an employee share scheme
18 @83A-305	Acquisition by associates
19 @83A-310	Forfeiture etc. of share or right
20 @83A-315	Working out existence and amount of discount
21 @83A-320	Interests in a trust
22 @83A-325	Application of Division to relationships similar to employment
23 @83A-330	Application of Division to ceasing employment
24 @83A-335	Application of Division to stapled securities

25 **@83A-300 Acquiring a share or right under an employee share**  
26 **scheme**

27 An individual \*acquires a \*share or right under an \*employee share  
28 scheme if the individual acquires the share or right in relation to  
29 any employment of the individual (including past or prospective  
30 employment).

31 **@83A-305 Acquisition by associates**

32 If an \*associate (other than an employee share trust) of an  
33 individual \*acquires a \*share in a company (or a right to acquire a  
34 share in a company) in relation to the individual's employment, for

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1 the purposes of this Division, treat the individual (instead of the  
2 associate) as having made that acquisition of the share or right.

3 **@83A-310 Forfeiture etc. of share or right**

4 This Division (apart from this Subdivision) is taken never to have  
5 applied in relation to a \*share or right that an individual \*acquired  
6 under an \*employee share scheme if:

- 7 (a) disregarding this section, an amount is included in the  
8 individual's assessable income under this Division in relation  
9 to the share or right; and  
10 (b) either:  
11 (i) the individual forfeits the share or right; or  
12 (ii) in the case of a right—the individual loses the right  
13 without having exercised it or disposed of it; and  
14 (c) the forfeiture or loss is not the result of:  
15 (i) a choice made by the individual; or  
16 (ii) a condition of the scheme that has the effect of  
17 protecting (wholly or partly) the individual against a fall  
18 in the \*market value of the share or right.

19 **@83A-315 Working out existence and amount of discount**

20 If the regulations specify an amount for the purposes of this  
21 section, use that amount instead of the \*market value of the \*share  
22 or right in working out:

- 23 (a) whether there is a discount given in relation to a share or  
24 right \*acquired under an \*employee share scheme; and  
25 (b) if so—the amount of the discount.

26 **@83A-320 Interests in a trust**

- 27 (1) This section applies if, at a time  
28 (a) you hold an interest in a trust whose assets include \*shares;  
29 and  
30 (b) that interest corresponds to a particular number of the shares  
31 (even if the interest does not correspond to particular shares).  
32 (2) For the purposes of this Division, treat yourself as holding at that  
33 time a beneficial interest in a number of the \*shares included in the  
34 assets of the trust equal to the number mentioned in  
35 paragraph (1)(b).

- 1 (3) If there are 2 or more classes of \*shares included in the assets of  
 2 the trust, this section operates separately in relation to each class as  
 3 if the shares in that class were all the shares included in the assets  
 4 of the trust.
- 5 (4) This section applies to rights in the same way it applies to \*shares.

6 **@83A-325 Application of Division to relationships similar to**  
 7 **employment**

8 This Division applies to an individual covered by column 1 of an  
 9 item in the table as if:

- 10 (a) he or she were employed by the entity referred to in column 2  
 11 of that item; and
- 12 (b) the thing referred to column 3 of that item constituted that  
 13 employment.

14 **Application of Division to relationships similar to employment**

Item	This Division applies to an individual who:	As if he or she were employed by:	And this constituted that employment:
1	receives, or is entitled to receive, *work and income support related withholding payments and benefits (otherwise than as an employee)	the entity that pays or provides the work and income support related withholding payments and benefits (or is liable to do so)	the relationship because of which the entity pays or provides the work and income support related withholding payments and benefits to the individual (or is liable to do so)
2	is engaged in service in a foreign country as the holder of an office	the entity by whom the individual is so engaged	the holding of the office
3	provides services to an entity (other than services covered by a previous item in this table and services provided as an employee)	the entity	the *arrangement between the individual and the entity under which those services are provided

15 **@83A-330 Application of Division to ceasing employment**

- 16 For the purposes of this Division, you are treated as ceasing  
 17 employment when you are no longer employed by any of the  
 18 following:



- 
- 1 (a) your employer in that employment;  
2 (b) a holding company (within the meaning of the *Corporations*  
3 *Act 2001*) of your employer;  
4 (c) a \*subsidiary of your employer or of a holding company  
5 (within the meaning of the *Corporations Act 2001*) of your  
6 employer.

7 **@83A-335 Application of Division to stapled securities**

- 8 (1) This Division applies in relation to a stapled security in the same  
9 way as it applies in relation to a \*share in a company, if at least one  
10 of the \*ownership interests that are stapled together to form the  
11 stapled security is a share in the company.

12 Note: This means the Division also applies to rights to acquire such a stapled  
13 security in the same way it applies to rights to acquire a share.

- 14 (2) This Division applies in relation to a stapled security in the same  
15 way as it applies in relation to an ordinary \*share in a company, if  
16 at least one of the \*ownership interests that are stapled together to  
17 form the stapled security is an ordinary share in the company.

- 18 (3) For the purposes of this Division, in relation to a stapled security or  
19 right to \*acquire a stapled security, a company is taken to include  
20 (as part of the company) each \*stapled entity for the stapled  
21 security, if at least one of the \*ownership interests that are stapled  
22 together to form the stapled security is a \*share in the company.

23 **2 Subsection 995-1(1)**

24 Insert:

25 *TFN withholding tax (ESS)* means tax payable in accordance with  
26 section 14-155 in Schedule 1 to the *Taxation Administration Act*  
27 *1953*.

28 **3 Subsection 995-1(1)**

29 Insert:

30 *work and income support related withholding payments and*  
31 *benefits* has the meaning given by subsection 6(1) of the *Income*  
32 *Tax Assessment Act 1936*.

33 ***Taxation Administration Act 1953***

34 **4 At the end of Division 14 in Schedule 1**

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Add:

**Subdivision 14-C—Shares and rights under employee share schemes**

**Table of sections**

14-155	Liability for TFN withholding tax (ESS)
14-160	ESS employer may recover TFN withholding tax (ESS) from ESS employee
14-165	Application of rules in Division 18
14-175	Overpayment of TFN withholding tax (ESS)
14-180	Application of certain provisions of Division 83A of the <i>Income Tax Assessment Act 1997</i>

**14-155 Liability for TFN withholding tax (ESS)**

- (1) \*TFN withholding tax (ESS) is payable if:
    - (a) a person (the *ESS employer*) provides one or more \*shares or rights to another person (the *ESS employee*); and
    - (b) the ESS employer did so as the employer of the ESS employee; and
    - (c) as a result:
      - (i) the ESS employee \*acquired the shares or rights under an \*employee share scheme; and
      - (ii) an amount is included in the ESS employee’s assessable income under Division 83A of the *Income Tax Assessment Act 1997* for an income year; and
    - (d) the ESS employee did not \*quote his or her \*tax file number to the ESS employer before the end of that income year; and
    - (e) if the ESS employee acquired the shares or rights in relation to any services provided to the ESS employer in the course or furtherance of an \*enterprise \*carried on by the ESS employee—the ESS employee has an \*ABN, and has not \*quoted it to the ESS employer, before the end of that income year.
  - (2) For the purposes of paragraph (1)(c), disregard section @83A-25 of the *Income Tax Assessment Act 1997*.
  - (3) The \*TFN withholding tax (ESS) is payable by the ESS employer.
  - (4) The \*TFN withholding tax (ESS) is due and payable at the end of 21 days after the end of the income year referred to in paragraph (1)(c).
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- 1 Note 1: When it is due and payable, the TFN withholding tax (ESS) is payable  
2 to the Commissioner: see paragraph 255-5(1)(b).
- 3 Note 2: An entity by whom it is payable must pay it to the Commissioner in  
4 accordance with Subdivision 16-B: see subsection 16-70(4). If any of  
5 it remains unpaid, the entity is liable to pay general interest charge:  
6 see section 16-80.
- 7 Note 3: The Commissioner may defer the time at which TFN withholding tax  
8 (ESS) becomes due and payable: see section 255-10.

9 **14-160 ESS employer may recover TFN withholding tax (ESS) from**  
10 **ESS employee**

- 11 (1) The ESS employer may recover from the ESS employee as a debt  
12 any of the \*TFN withholding tax (ESS) that it pays.
- 13 (2) The ESS employer is entitled to set off an amount that it can  
14 recover from the ESS employee under this section against a debt  
15 due by it to the ESS employee.

16 **14-165 Application of rules in Division 18**

17 These provisions:

- 18 (a) subsection 18-15(1) and sections 18-20 and 18-25 (about  
19 credits for amounts withheld from withholding payments);  
20 and  
21 (b) sections 18-65 and 18-70 (about refunds for overpaid  
22 withheld amounts);

23 apply as if any of the \*TFN withholding tax (ESS) that has been  
24 paid were an amount withheld under section 12-35 from a  
25 \*withholding payment covered by that section.

26 **14-175 Overpayment of TFN withholding tax (ESS)**

27 If \*TFN withholding tax (ESS) has been overpaid:

- 28 (a) the Commissioner must refund the amount overpaid; and  
29 (b) the ESS employee is not entitled to a credit under  
30 section 18-15, 18-20 or 18-25 in respect of the amount  
31 overpaid.

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1 **14-180 Application of certain provisions of Division 83A of the**  
2 ***Income Tax Assessment Act 1997***

3 The following provisions of the *Income Tax Assessment Act 1997*  
4 have effect for the purposes of this Subdivision in the same way as  
5 they have for the purposes of Division 83A of that Act:

- 6 (a) section @83A-305 (about associates);  
7 (b) section @83A-315 (about the discount);  
8 (c) section @83A-325 (about relationships similar to  
9 employment);  
10 (d) section @83A-335 (about stapled securities).

11 **5 After subsection 16-70(3) in Schedule 1 (before the note)**

12 Insert:

- 13 (4) An entity that must pay an amount to the Commissioner under  
14 Subdivision 14-C must do so in accordance with sections 16-80  
15 and 16-85.

16 **6 Section 16-80 in Schedule 1**

17 Omit “or (3)”, substitute “, (3) or (4)”.

18 **7 After Division 391 in Schedule 1**

19 Insert:

20 **Division 392—Employee share scheme reporting**

21 **Table of Subdivisions**

22		Guide to Division 392
23	392-A	Statements
24	392-B	Miscellaneous

25 **Guide to Division 392**

26 **392-1 What this Division is about**

27 

An employer who provides shares or rights to an employee under 28 an employee share scheme during a year must, at the end of the 29 year, give certain information to the Commissioner and to the 30 employee.
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Note: For the tax treatment of employee share schemes, see Division 83A of the *Income Tax Assessment Act 1997*.

**Subdivision 392-A—Statements**

**Table of sections**

392-5 Statements by employers  
392-10 Change or omission in information given to the Commissioner

**392-5 Statements by employers**

- (1) An employer of an employee must give the Commissioner and the employee a statement for a \*financial year if:
    - (a) all of the following apply:
      - (i) the employer provides \*shares or rights to the employee under an \*employee share scheme during the year;
      - (ii) a discount is given in relation to the shares or rights; or
    - (b) all of the following apply:
      - (i) the employer has previously provided shares or rights to the employee under an employee share scheme;
      - (ii) a discount was given in relation to the shares or rights;
      - (iii) the \*ESS deferred taxing point for the shares or rights occurs during the year.
- Note: Section 286-75 provides an administrative penalty for breach of this subsection.
- (2) Paragraph (1)(a) does not apply to the provision of a \*share under an \*employee share scheme as the result of exercising a right acquired under the scheme.
  - (3) The statement must be in the \*approved form.
  - (4) The \*approved form may require the statement to contain the following information:
    - (a) the following information about the employee:
      - (i) the employee’s name and address;
      - (ii) if the employee has quoted the employee’s \*tax file number to the employer—that tax file number;
      - (iii) if the employee has \*quoted the employee’s \*ABN to the employer—that ABN;
    - (b) if paragraph (1)(a) applies—the following information about the \*shares or rights:



- 
- 1 (i) the number of the shares or rights;
- 2 (ii) the amount paid, at or before the time of \*acquisition,
- 3 towards acquiring the shares or rights;
- 4 (iii) the employer's estimate of the \*market value of the
- 5 shares or rights at the time of acquisition;
- 6 (c) if paragraph (1)(b) applies—the following information about
- 7 the shares or rights:
- 8 (i) the number of the shares or rights;
- 9 (ii) the amount paid, after the time of acquisition but before
- 10 the \*ESS deferred taxing point, towards acquiring the
- 11 shares or rights;
- 12 (iii) the employer's estimate of the market value of the
- 13 shares or rights at the ESS deferred taxing point;
- 14 (d) if the employee has quoted neither his or her tax file number
- 15 nor his or her ABN to the employer—the amount of \*TFN
- 16 withholding tax (ESS) paid by the employer in respect of the
- 17 shares or rights during the year;
- 18 (e) in the case of the statement given to the Commissioner—the
- 19 employer's ABN.
- 20 (5) Subsection (4) does not limit the information that the \*approved
- 21 form may require the statement to contain.
- 22 (6) The statement must be given:
- 23 (a) to the employee no later than 14 July after the end of the
- 24 year; and
- 25 (b) to the Commissioner no later than 14 August after the end of
- 26 the year.
- 27 Note: Section 388-55 allows the Commissioner to defer the time for giving
- 28 an approved form.

29 **392-10 Change or omission in information given to the**

30 **Commissioner**

- 31 (1) If the employer becomes aware of a material change or material
- 32 omission in any information given to the Commissioner under this
- 33 Division, the employer must:
- 34 (a) tell the Commissioner of the change in the \*approved form;
- 35 or
- 36 (b) give the omitted information to the Commissioner in the
- 37 approved form.
- 38 Note: Section 286-75 provides an administrative penalty for breach of this
- 39 subsection.
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1 (2) Information required by subsection (1) must be given no later than  
2 30 days after the employer becomes aware of the change or  
3 omission.

4 Note: Section 388-55 allows the Commissioner to defer the time for giving  
5 an approved form.

## 6 Subdivision 392-B—Miscellaneous

### 7 Table of sections

8 392-15 Application of certain provisions of Division 83A of the *Income Tax*  
9 *Assessment Act 1997*

#### 10 392-15 Application of certain provisions of Division 83A of the 11 *Income Tax Assessment Act 1997*

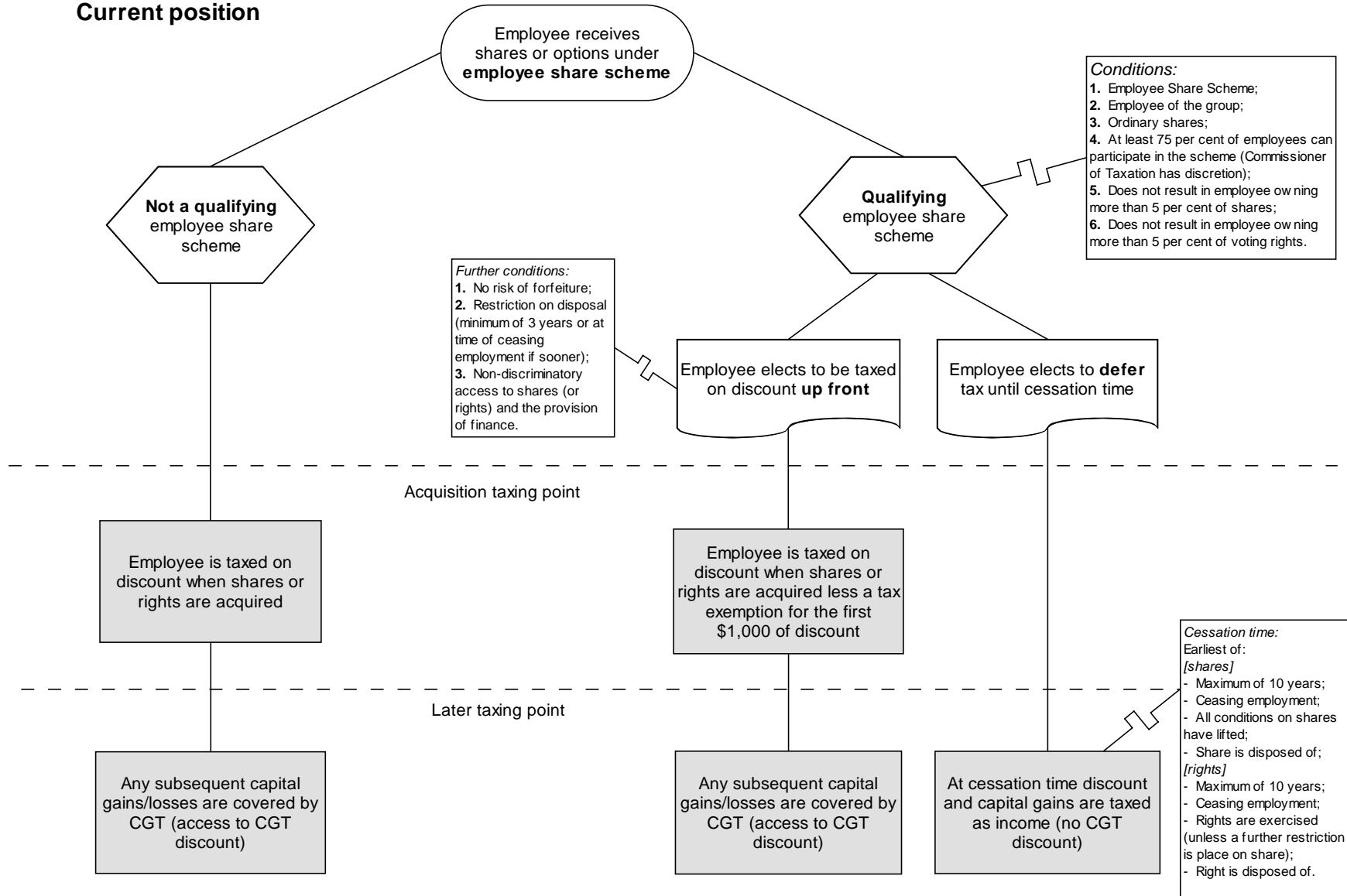
12 The following provisions of the *Income Tax Assessment Act 1997*  
13 have effect for the purposes of this Division in the same way as  
14 they have for the purposes of Division 83A of that Act:

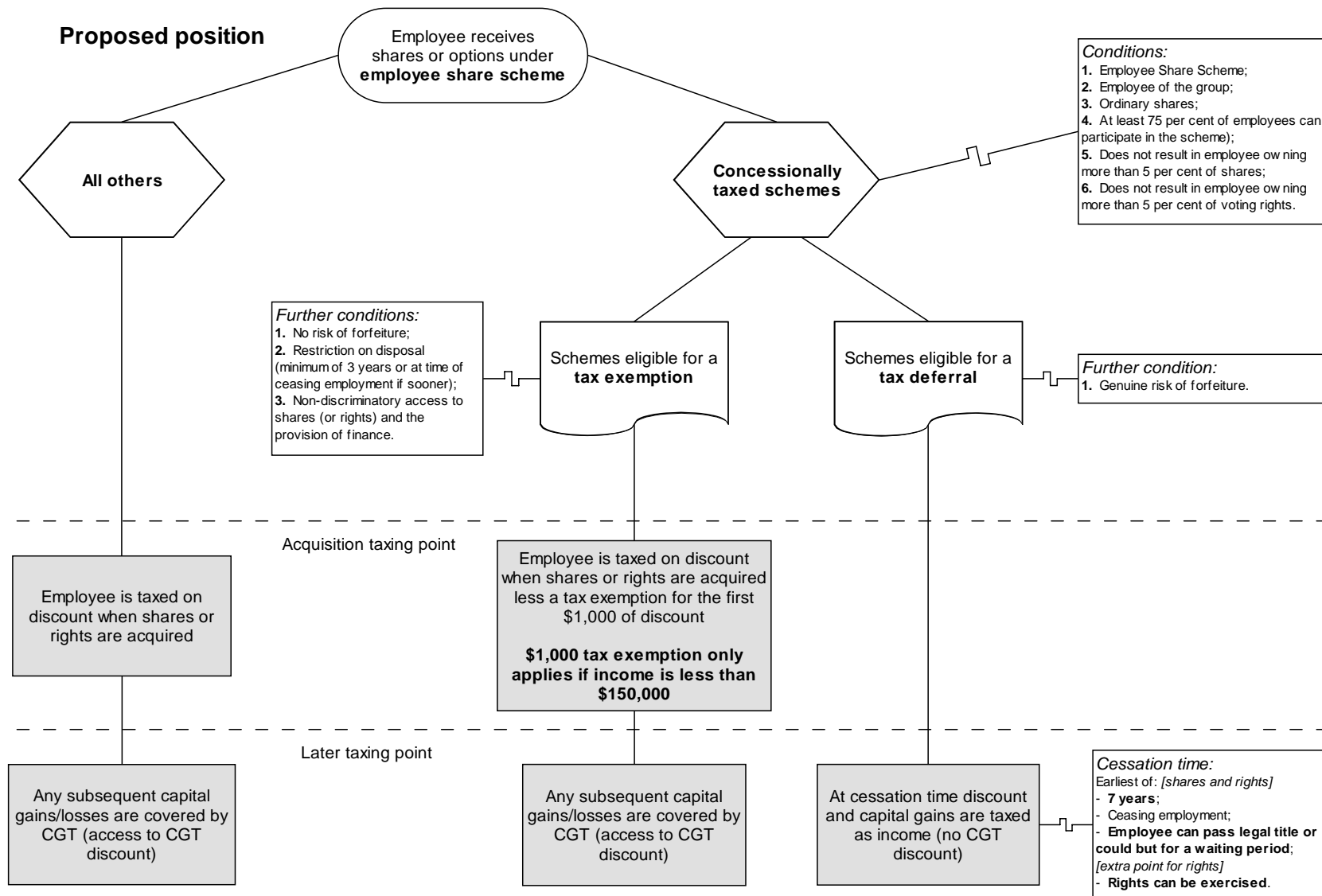
- 15 (a) section @83A-305 (about associates);  
16 (b) section @83A-315 (about the discount);  
17 (c) section @83A-325 (about relationships similar to  
18 employment);  
19 (d) section @83A-335 (about stapled securities).



# APPENDIX B – DIAGRAMS

## Current position





# APPENDIX C – INTERACTION WITH G20/APRA REVIEW OF EXECUTIVE REMUNERATION

## BACKGROUND

125. Examining the causes of the global financial crisis has revealed that a number of financial market vulnerabilities may have been exacerbated by misaligned incentives promoting excessive risk-taking by company executives. A number of financial institutions around the world remunerated employees in a way that encouraged short-term risks at the expense of the longer-term interests of the company.

## THE WORK OF THE FINANCIAL STABILITY BOARD AND G20 LEADERS

126. Executive remuneration was considered at the G-20 Leaders’ meeting in Washington DC in November 2008. Leaders agreed that by 31 March 2009, the International Monetary Fund, an expanded Financial Stability Forum (now the Financial Stability Board (FSB)) and other regulators would develop sound practice guidelines for compensation schemes for company executives.

127. APRA participated in a working group of the FSB which was tasked with developing principles in this area to guide global reform. The FSB principles were endorsed by the G-20 Leaders at the London Summit on 2 April 2009. The G20 Leaders agreed that national supervisors should progress the implementation of the following principles in 2009.

<b>FSB principles for sound compensation practices</b>	
<b>Effective governance of compensation</b>	
Principle 1.	The firm’s board of directors must actively oversee the compensation system’s design and operation.
Principle 2.	The firm’s board of directors must monitor and review the compensation system to ensure the system operates as intended.
Principle 3.	Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.
<b>Effective alignment of compensation with prudent risk taking</b>	
Principle 4.	Compensation must be adjusted for all types of risk.
Principle 5.	Compensation outcomes must be symmetric with risk outcomes.
Principle 6.	Compensation payout schedules must be sensitive to the time horizon of risks.
Principle 7.	The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

### **Effective supervisory oversight and engagement by stakeholders**

- Principle 8. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
- Principle 9. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

## **APRA DISCUSSION PAPER ON SOUND EXECUTIVE REMUNERATION PRACTICES**

128. In October 2008, the Prime Minister announced that APRA would develop a template that could be adopted by international authorities and that linked capital adequacy requirements to executive remuneration in a way that discourages excessive risk-taking in Australian financial institutions.
129. On 28 May 2009, APRA released a discussion paper and accompanying material for consultation on how it would implement the FSB's remuneration principles in Australia. The new requirements will apply to APRA-regulated deposit-taking institutions and insurance companies. The consultation period closes on 24 July 2009. The new approach is intended to become effective from 1 January 2010.
130. Consistent with the FSB principles, APRA proposes that each APRA-regulated institution have in place a written and comprehensive remuneration policy, and establish a board remuneration committee comprised of independent directors. APRA's requirements will apply not only to company executives but also to risk and financial control personnel and all other employees for whom a significant portion of total remuneration is variable and determined by performance measures.
131. An institution's remuneration policy must be designed to encourage behaviour that supports the institution's long-term financial soundness and its risk management framework. The remuneration policy must allow for adjustments to reflect the time necessary for the outcomes of those business activities to be reliably measured. To this end, performance-based remuneration arrangements must specify measures of performance, the mix of forms of remuneration (such as fixed and variable components, and cash and equity-related benefits) and when the individual becomes eligible to receive payment.
132. The proposed changes to the prudential standards also require that the remuneration policy enable the board to defer, reduce or eliminate payment of performance-based remuneration.

## APPENDIX D – INTERNATIONAL COMPARISONS

### UNITED STATES

#### SHARES

1. If shares are fully vested when received, the employee must include an amount in income at that time equal to the value of the shares less the amount paid for them. Otherwise tax will be payable at the time shares vest on the value of the shares at the vesting time. An employee can elect to report the value of shares as income when the shares are acquired instead of the year they vest.

#### OPTIONS

2. In the US, employee stock options are categorised as one of two types for taxation purposes:
  - Non-statutory stock options which are taxed under general principles of compensation and income; and
  - Statutory stock options which include incentive stock options (ISOs) and employee stock purchase plans (ESPPs).

#### Non-statutory schemes

3. The taxation treatment of this class of options is as follows:
  - Options are taxable upon grant if there is a readily ascertainable fair market value, with capital gain or loss arising on disposal.<sup>14</sup>
  - If there is no readily ascertainable fair market value, the option is taxed on exercise. The taxable value is the fair market value of the stock minus any amount paid for the stock or option and is included in ordinary income. Any subsequent gains are treated as capital gains. Taxation may be deferred if there is substantial risk of forfeiture or stock is not transferable.
  - An election can be made so that compensatory income can be converted into more concessionally taxed capital gains.<sup>15</sup> Where an election is made within 30 days of acquiring the option, the excess of the fair market value of the underlying shares at the grant date over any employee contributions

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<sup>14</sup> This taxation treatment does not generally apply because the property is not considered to be readily transferable.

<sup>15</sup> While short-term capital gains are taxed as ordinary income, the long-term capital gain tax for plan investments held over one year is currently capped at 15%.

is taxed to the employee as ordinary income. On disposal, the excess is taxed as either a short-term or long-term capital gain.

- Tax deductions are available for an employer but can be delayed until an amount is included in the employee's income.
4. Generally when an option is exercised, employers are required to report the excess of the fair market value received over the amount the employer paid for that stock.

## **Statutory schemes**

5. These plans are shareholder-approved plans under which employees are granted options to purchase shares of their employer's stock (or related corporation).
6. The main differences between ISOs and ESPPs are:
  - The exercise price for an ESPP may be less than the fair market value of the corporation's stock at the time the option is granted; and
  - ESPPs are generally granted to all employees whereas ISOs can be limited to key employees.
7. For both schemes, the employer is generally not able to claim deductions.
8. There are stringent reporting requirements for these schemes both on the employee and the employer. An employer has a responsibility to report the amount of deferrals for a tax year.

## **Employee stock purchase plan**

9. There is no tax on the grant of the right or the exercise of it. Any discount on the share is taxed as ordinary income at the time the share is disposed of. The discount is the amount by which the fair market value of the share at the beginning of the offering period, exceeds the exercise price. Further gains are treated as capital gains.
10. Under an ESPP, employees can be offered at most, a 15 per cent discount on current share price. However, to obtain concessional tax treatment shares purchased under the option must not be sold within 2 years from the grant of the option and one year after the shares are transferred. The employee must have no more than 5 per cent of the voting power or value of the employer's stock (or related company).
11. This plan is used by employers as a method for employees to purchase stock, usually using payroll deductions to pay for the shares. If an employee forgoes salary and wages to acquire the remainder of a purchase, they are taxed on that amount as salary in the year the share is purchased.

## **Incentive stock options**

12. Similar to ESPPs, taxation is deferred until the time of disposal with gains treated as a capital gain subject to the same holding period being met. The exercise price may not be less than the fair market value of the stock at the time the option is granted (i.e., there is no discount).

13. The employee must have no more than 10 per cent of the voting power or value of the employer's stock. If the employee has options vest with an underlying share value of more than \$100,000 (valued at the time the options were issued) in any income year, any increase in value of options over the \$100,000 threshold is treated as ordinary income.
14. Employees who hold ISOs may also be affected by the alternative minimum tax (AMT). The difference between the exercise price and the fair market value of the stock must be included by the ISO recipient as an adjustment in computing the AMT income in the year of exercise. The AMT system has in general a broader definition of taxable income, a larger exemption, and lower tax rates than the regular system.

## **UNITED KINGDOM**

15. There are four types of arrangements in the UK that offer tax preferred treatment. Two of them must be offered to all employees in the company who meet the basic qualification requirements (share incentive plans and savings-related share option schemes). The other two types of schemes can be offered to employees on a selective basis. With the exception of the Enterprise Management Incentive, it is necessary to obtain the approval of HM Revenue and Customs (HMRC) for the schemes prior to the grant of an award.
16. Not all employee share schemes are approved by the government and therefore do not have the same tax advantages. The employee will pay income tax and national insurance when they exercise the option to buy shares for less than their value. Any capital gains tax liability will be based on the price the employee paid for the shares when they were granted.

## **SHARE INCENTIVE PLANS**

17. Employers can give employees up to £3,000 of shares each year, free of tax and national insurance provided the shares have been held in the plan for 5 years.
18. If an employee keeps their shares in the plan until they sell them, they do not have to pay CGT on any gains they make. If the shares are sold sometime after exiting the plan, CGT will apply.
19. Employees can also buy partnership shares under which a company deducts money from an employee's gross pay, up to a maximum of £1,500 each year, again free of tax and national insurance. An employer can provide up to two free matching shares for every partnership share bought. The amount of tax payable on partnership and matching shares depends on how long they have been in the plan. There is no income tax if the shares are held more than 5 years.
20. There is no tax charged on certain dividends to buy further shares that are held in the plan for at least three years.
21. Free and matching shares can be forfeited if the employee ceases employment with the company. Performance conditions can also be imposed.



22. Companies must set up a trust to hold the shares. Companies or a trustee must record and monitor awards of shares to ensure correct tax treatment when employees take their shares out of the plan. The company or trustee will be responsible for PAYE or national insurance obligations.

## **SAVINGS RELATED SHARE OPTION SCHEMES**

23. Employees may have to be employed for a period of up to 5 years to be an eligible employee. The employer grants an employee options to buy the employer's shares in 3, 5 or 7 years time at the current market value or at a discount of up to 20 per cent of that price. No income tax is payable on grant of the options and employees are not normally taxed when their savings are used to buy shares.
24. Participants must enter into a special savings contract with a building society or bank designated by their employer to buy the shares at the end of the fixed term. The amount that the employee agrees to save each month is normally taken direct from their net after-tax pay. Employees must agree to save between £5 and £250 per month.
25. When shares acquired by the exercise of an option are disposed of, the capital gain is calculated as the amount received from the sale of the shares, less the price paid for the shares and the amount of any gain chargeable to income tax on the exercise of the option.
26. Employers may impose restrictions so that employees are required to sell all shares upon cessation of employment, and that shares be sold when acquired, if the acquisition occurs after cessation of employment.

## **COMPANY SHARE OPTION PLANS (CSOP)**

27. The company can choose which employees and directors to which it wishes to grant options. Employees and directors cannot hold options over shares valued at more than £30,000 at the date of grant of the relevant option.
28. No income tax is payable on grant of the options and provided that the option is exercised more than three years after grant (but not more than 10 years after grant) the gain on exercise will not be subject to income tax.
29. When shares are disposed of, the capital gain is calculated as the difference between the amount received from the sale of the shares and the exercise price paid. The capital gains tax rate is lower than the income tax rate for most employees, and capital gains which fall below the annual exempt amount are not taxable.
30. Participation is not open to employees who own more than 25 per cent of the company.
31. Employers may impose restrictions so that employees and directors are required to sell all shares upon cessation of employment, and that shares be sold when acquired, if the acquisition occurs after cessation of employment.

## **ENTERPRISE MANAGEMENT INCENTIVE SCHEME**

32. This scheme is designed to reward employees for investing their time and skills in small companies. The company must have gross assets of no more than £30 million and fewer than 250 employees. There are also excluded businesses such as banking, insurance and farming.
33. Under the scheme, each employee can be granted options over shares with a value of up to £120,000. There is no tax on the grant of the option or when the option is exercised, unless the option has an exercise price which is less than the market value of the shares on the date of grant. If it does, this discount will be subject to income tax at the date of exercise. When the shares are sold, CGT will apply from the date on which the options were granted.
34. Options do not need to be provided at market value, but may be discounted including to nil.
35. If shares are acquired that are restricted or that carry the risk of forfeiture income tax may arise after the restrictions are lifted
36. The options must be granted to recruit or retain employees in a company and not to avoid tax. To qualify for tax relief the grant of the option has to be notified to HMRC.

## APPENDIX E – VALUATION ISSUES (ACCOUNTING TREATMENT)

### Accounting requirements for share-based payments

#### Overview

1. Australian accounting requirements for share-based payments are set out in AASB 2 *Share-based Payment* in accordance with an international framework which has been adopted in over 100 countries. As such, AASB 2 has the same requirements as the International Accounting Standards Board's IFRS 2 *Share-based Payment*.
2. AASB 2 deals with accounting for all share-based payment transactions, including those related to acquiring employee services, which typically involve shares or options to acquire shares.
3. In respect of employee services, the AASB 2 model is designed to result in employee expenses being recognised as the relevant employee services are provided. This generally occurs evenly over the vesting period. In the case of options to buy shares, adjustments are made at each accounting date to reflect the best estimate of the number of options expected to eventually vest.
4. The expense is measured at the fair value of the equity instruments as at their grant date. A market price for shares or options to buy shares would be used as the basis for determining fair value when available.

#### Valuation of options where a market price is unavailable

5. It is common for market prices to be unavailable for options to buy shares that have the same terms and conditions as those granted to employees, in which case a valuation model must be applied. AASB 2 requires generally-accepted option pricing models to be applied that take into account, as a minimum:
  - exercise price;
  - option life;
  - current price of underlying shares;
  - expected share price volatility;
  - expected dividends, if any; and
  - risk-free interest rate over the option life.
6. For options to buy shares with relatively short contractual lives, or that must be exercised within a short period of time after vesting date, the Black-Scholes-Merton formula may produce an appropriate valuation. However, that formula does not allow for the possibility of exercise before the end of the option's life or for the possibility that expected volatility and other model inputs might vary over the option's life. Accordingly, for share options with long lives, a more comprehensive formula would generally need to be applied in order to adequately take account of the above six factors.

7. If it is not possible to measure a fair value for options to acquire shares, intrinsic value is used, being the difference between the fair value of the shares and the price to be paid for the shares by the employees.