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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

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EXPOSURE DRAFT: TAX LAWS AMENDMENT (2009 BUDGET  
MEASURES No. 2) BILL 2009  
EXPOSURE DRAFT: INCOME TAX (TFN WITHHOLDING TAX (ESS))  
BILL 2009

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EXPLANATORY MATERIALS

(Circulated by the authority of the  
Treasurer, the Hon Wayne Swan MP)







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# Glossary

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The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
ABN	Australian Business Number
ATO	Australian Taxation Office
CGT	Capital Gains Tax
Commissioner	Commissioner of Taxation
ESS	Employee Share Scheme
FBT	Fringe Benefits Tax
FBTAA 1986	<i>Fringe Benefits Tax Assessment Act 1986</i>
GST Act	<i>A New Tax System (Good and Services Tax) Act 1999</i>
IT(TP)A 1997	<i>Income Tax (Transitional Provisions) Act 1997</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
TAA 1953	<i>Taxation Administration Act 1953</i>
TFN	Tax File Number



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# General outline and financial impact

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## Employee share schemes

Schedule 1 to this Bill reforms the taxation of employee share schemes by:

- replacing the current Division 13A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936); and
- inserting a new Division 83A in to the *Income Tax Assessment Act 1997* dealing with employee share schemes, a new Subdivision 14-C in Schedule 1 of the *Taxation Administration Act 1953* (TAA 1953) dealing with shares and rights under employee share schemes, and a new Division 392 of Schedule 1 of the TAA 1953 dealing with employee share scheme reporting.

**Date of effect:** The changes apply to shares, rights and stapled securities acquired on and after 1 July 2009.

In order to simplify the law and improve the interaction of the employee share scheme rules with other areas of the law, shares, rights and stapled securities acquired before this time will also be brought within the new rules. However, transitional arrangements will be provided to ensure the effect of the existing law is maintained for securities acquired before 1 July 2009.

**Proposal announced:** This measure was first announced in the 2009-10 Budget and in Treasurer's Media Release No. 065 of 12 May 2009. Final details of the measure were announced in Assistant Treasurer's Media Release No. 011 of 1 July 2009.

**Financial impact:** This measure is estimated to have the following revenue impact over the forward estimate period:

<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>	<i>Total</i>
\$0m	\$35m	\$45m	\$55m	\$135m

**Compliance cost impact:** Low.



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# **Chapter 1**

## ***Reforming the taxation of employee share schemes***

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### **Outline of chapter**

- 1.1 Schedule 1 to this Bill reforms the taxation of employee share schemes by:
- replacing the current Division 13A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936); and
  - inserting into a new Division 83A in the *Income Tax Assessment Act 1997* dealing with employee share schemes, a new Subdivision 14-C in Schedule 1 of the *Taxation Administration Act 1953* (TAA 1953) dealing with shares and rights under employee share schemes, and a new Division 392 of Schedule 1 of the TAA 1953 dealing with employee share scheme reporting.

### **Context of amendments**

#### **History**

1.2 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 benefits tax applies, the income tax law would treat the discount as non-assessable non-exempt income to avoid double taxing the benefit.

1.3 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. Double taxation is

avoided because the fringe benefits law excludes benefits assessed under Division 13A.

1.4 Division 13A was introduced in 1995 to counter the arrangements which exploited the then existing legislation (section 26AAC of the ITAA 1936). Division 13A sought to ensure that the concessions available were directed at employee share schemes which encourage investment by employees in their employer company, or in their employer company's holding company, and which are broadly available to all permanent employees.

1.5 The law governing the taxation of benefits of employee share schemes was previously located in section 26AAC of the ITAA 1936, which applied from 1974. Generally, this section applies to the acquisition of a share or right before 28 March 1995. In 1974, section 26AAC replaced section 26(e) of the ITAA 1936 as the basis for taxing benefits acquired under an employee share scheme following a court case which highlighted situations where paragraph 26(e) was found to be insufficient.

1.6 In order to simplify the existing arrangements, the new rules have been rewritten into the ITAA 1997.

### **Outline of existing law**

1.7 Under the current arrangements, employees who take part in an employee share scheme are required to pay tax on any discount on the market value of a share or right they receive from their employer. This is currently the case in relation to both qualifying share schemes and non-qualifying share schemes.

1.8 Division 13A starts by taxing all discounts upfront. However, an employee participating in a qualifying employee share scheme that satisfies certain conditions, can elect to be taxed on the discount in the year they acquire the shares or rights and receive the benefit of a reduction of the discount by up to a \$1,000 (the 'upfront concession'). The reduction is a tax concession.

1.9 Under the upfront 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.

1.10 If an employee participating in a qualifying employee share scheme does not make an election to be taxed upfront, they receive the benefit of the 'tax-deferred concession'.

1.11 Under the tax-deferred concession, there is no \$1,000 exemption but the employee defers paying tax on the discount until the 'cessation time'. A cessation time occurs at the earliest of the following:

- when the employee sells the shares or exercises the rights;
- when the employment ceases;
- 10 years after the shares or rights were acquired; and
- the later of:
  - when restrictions on sale are lifted; and
  - when forfeiture conditions cease to have effect.

1.12 Any increase in value of the shares or rights (before the cessation time) is included in assessable income at the cessation time under Division 13A. Therefore, the CGT discount is not available to gains accrued before the cessation time. If a share or right is not sold within 30 days of the cessation time, any capital gains accrued after the cessation time remain subject to CGT, including the CGT discount, if available.

1.13 In comparison, if the shares or rights are issued under a non-qualifying scheme, the employee is taxed on the discount when they acquire the shares or rights. This means they do not enjoy the tax benefits associated with qualifying employee share schemes.

## **Budget announcement and changes**

1.14 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. The new measures will also protect Commonwealth revenues needed to support jobs and invest in vital nation-building in the face of the global recession.

1.15 The Budget savings measure was designed to improve horizontal equity in the tax system by treating all forms of remuneration more consistently, to target employee share scheme tax concessions more closely to low and middle income earners, and to reduce the scope for losses to the Commonwealth revenue through tax evasion and avoidance.

1.16 The Budget measure announced that 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.

1.17 Following the Budget announcement, the Government issued a public consultation paper which sought to better understand the concerns of industry, and canvas a number of options to improve the taxation of employee share schemes.

1.18 On 1 July 2009, the Government issued a Policy Statement setting out the taxation of employee share schemes. This statement contained changes to the Budget announcement which took account of industry concerns expressed in consultation, while still addressing the acknowledged problems of tax evasion and tax avoidance.

1.19 Further consultation was then undertaken on the draft legislation.

1.20 The Board of Taxation will consider how best to determine the market value of employee share scheme benefits.

1.21 The Board of Taxation will also consider whether employees of start-up, research and development and speculative-type companies should benefit from a tax deferral arrangement despite not being subject to a real risk of forfeiture.

## **Summary of new law**

### **Objects**

1.22 The Bills reform the taxation of employee share schemes.

1.23 The employee share scheme tax rules tax the value of benefits received by employees under employee share schemes to ensure taxpayers are taxed consistently regardless of the forms of remuneration they receive.

1.24 However, the rules also specifically aim to improve the alignment of employee and employer interests. In recognition of the economic benefits derived from employee share scheme arrangements, the rules provide for tax concessions for employees participating in employee share schemes.

1.25 Tax support is provided on the grounds that aligning the interests of employees and employers encourages positive working relationships, boosts productivity through greater employee involvement in the business, reduces staff turnover and encourages good corporate governance.

## **Upfront taxation**

1.26 Generally, any discount to the market value of ESS interests in shares or rights provided under an employee share scheme is taxed upfront on acquisition. That means that the market value of the discount must be included in an employee's assessable income for that income year.

1.27 A \$1,000 tax exemption is available to taxpayers participating in an employee share scheme who pay tax upfront, if they have a taxable income (after adjustments) of \$180,000 or less, and the employee and the scheme meet certain conditions.

1.28 The other conditions for the upfront concession are :

- the employee must be employed;
- the scheme must be offered to at least 75 per cent of permanent employees;
- the shares or rights provided must not be at real risk of forfeiture;
- the shares or rights must be required to be held by the employee for three years or until the employee ceases employment; and
- the employee must not receive more than five per cent ownership of the company, or control more than five per cent of the voting rights in the company, as a result participating in the scheme.

## **Deferred taxation**

1.29 Although 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 upfront in the same manner, exceptions to this general principle are made for two forms of employee share scheme – schemes where the ESS interests are at real risk of forfeiture, and schemes where the ESS interests are acquired under certain salary sacrifice arrangements.

1.30 Unlike the current law, whether a share or right is subject to taxation upfront or at a later time now depends on the structure of the scheme and not an election of the employee. This reduces the tax avoidance problems associated with the existing election arrangements and reduces compliance costs, because the employer can advise the employee of the taxation arrangements applying to that scheme.

1.31 For the deferred tax rules to apply:

- the relevant ESS interests must be acquired at a discount under an employee share scheme, the ESS interest must relate to ordinary shares and be subject to a real risk of forfeiture; or
- the relevant ESS interests must be acquired under a salary sacrifice arrangement, and the employee must receive no more than \$5,000 worth of shares under those arrangements in an income year.

***ESS interests at real risk of forfeiture***

1.32 In situations where there is a real risk that the benefits of shares or rights are never realised because the ESS interests are forfeited, deferral of taxation is considered the appropriate treatment.

1.33 An ESS interest is at real risk of forfeiture if a reasonable person would consider that there is a real risk that the employee would lose the interest, or never receive it, other than by selling or exercising it, or through the market value of the ESS interest falling to nil.

1.34 Providing for the deferral of tax in these situations recognises that the employee may never have a chance to recognise the economic value of the ESS interest, and that having employee remuneration ‘at risk’ in this manner is entirely consistent with the purpose of concessionally taxing employee share schemes, namely to align the interests of employees and employers.

***ESS interests provided through a salary sacrifice scheme***

1.35 The deferral arrangements also allow for ESS interests received at a discount through a salary sacrifice arrangement to be subject to deferred taxing treatment if the salary sacrifice arrangement is part of the employee’s remuneration package, in circumstances where it is reasonable to conclude that the salary or wages would be greater if the interest was not made part of that package. The risk of forfeiture is not necessary to get deferred taxation treatment through a salary sacrifice scheme.

1.36 To be eligible for deferred taxation a salary sacrifice scheme must relate to shares not to rights, the employee must receive the shares, for no consideration payment (discount per share provided through the arrangement is equal to the market value of the share), and the employee must receive no more than \$5,000 worth of shares. Certain other conditions must be met.

1.37 Providing for deferred tax in the case of employee share schemes involving salary sacrifice arrangements ensures that employees utilising similar arrangements under the existing law will continue to be able to access these arrangements with minimal disruption. This encourages the broad availability of, and participation in, employee share schemes, and the broad alignment of the interests of employees and employers in Australia. This is particularly the case for low-to-middle employees, for whom \$5,000 of benefits is likely to have a greater significance.

***The ESS deferred taxing point***

1.38 When tax on an employee share scheme discount is deferred, it is deferred until the ESS deferred taxing point occurs.

1.39 The deferred taxing point for shares is the earliest of when:

- there is no real risk that the employee will lose the share under the conditions of the scheme other than by disposing of it and there are no restrictions preventing disposal; or
- when the employee ceases the employment in respect of which they acquired the share; or
- 7 years after the employee acquired the share.

1.40 The ESS deferred taxing points for rights are based on similar principles, with some additional conditions to account for situations which would only arise in relation to rights (for example because they can be exercised as well as disposed of).

**Protecting the integrity of employee share schemes**

1.41 The new rules are designed to protect the integrity of the taxation of employee share schemes. The new law reproduces a number of provisions in the current law and introduces a number of new integrity provisions.

***Interests provided to associates***

1.42 The new law continues to treat employee share scheme interests provided to associates of employees, in relation to an employee's employment, as though the interest was in fact acquired by the employee rather than the associate.

1.43 This provision is designed to ensure that arrangements are not artificially constructed to avoid the employee share scheme tax rules, or to

lessen a tax liability incurred in relation to ESS interests, by providing benefits to associates of an employee.

***Interests in a trust***

1.44 The new law is designed to ensure that when an employee has a beneficial interest in shares in a trust, that they will be taxed as though they were the legal owner of those shares. This is so that employees cannot lessen, delay or avoid their tax liability by interposing a trust.

***Withholding tax***

1.45 The new law introduces a withholding tax, applicable in limited circumstances, to ensure the integrity of the taxation of employee share schemes.

1.46 Withholding tax is payable if an employer provides discounted shares and rights to an employee, and that employee has not quoted their Tax File Number (TFN), or their Australian Business Number (ABN) to the employer by the end of the income year.

1.47 An employee refusing to provide their employer with a TFN or ABN (as the case requires) undermines the new law relating to employer reporting requirements, which are important to ensuring the tax integrity of employee share schemes.

1.48 It is rare for an employee to refuse to provide their employer with a TFN, so it is not expected that the withholding tax will be commonly levied.

***Employer reporting***

1.49 The new law requires employers who provide ESS interests to report certain information to the Commissioner, to enable him to ensure that the employee share scheme tax law is being complied with.

1.50 These reporting requirements boost the integrity of the taxation of share schemes, addressing concerns that the current employee share scheme rules are not being complied with, that the Commissioner is not in a position to know the full extent of that non compliance, and enabling the Commissioner to conduct data matching activities.

1.51 The legislation outlines some of the particular information that the Commissioner may require in the approved form. This is provided to better illustrate the intent of the employer reporting requirements, and to provide some guidance to employers and employees as to the sort of information the Commissioner might require.

1.52 The legislative guidance that is provided on what the Commissioner may require in the approved form does not in any way limit the information that the Commissioner may or may not require.

***Interests may relate to past or prospective employers***

1.53 An employee share scheme is defined as a scheme for providing ESS interests in a company to employees, (including past or prospective employees) of the employer.

1.54 The extension to past or prospective employees is an integrity measure to ensure that arrangements are not deliberately designed to occur before or after employment in order to avoid the employee share scheme rules. This is consistent with the general treatment of employment income elsewhere in the tax law.

**Deduction by employers**

1.55 Under the general income tax law, an employer would not be entitled to a deduction for directly providing shares or rights to shares in itself to its employees.

1.56 In order to encourage the provision of shares or rights under certain employee share schemes, a limited specific deduction is provided to employers. An employer can deduct an amount for shares or rights they provide to employees under an employee share scheme if the scheme meets the conditions for an employee to receive the upfront concession. The income test for the upfront concession is disregarded when calculating as employer's eligibility to claim a deduction.

1.57 A general deduction may be available in relation to the indirect provision of securities to employees under an employee share scheme. An employer may provide money to an employee share trust for the purpose of providing its employees with securities in itself. The employee share trust may acquire the securities by buying them on a market or by participating in a share issue by the employer.

**Foreign employment**

1.58 Consistent with the treatment of most other types of income, whether an amount is included in a taxpayer's assessable income under the new ESS rules will depend on the taxpayer's residency status and the source of the income.

**Refund of tax for forfeited shares**

1.59 The new law provides for a refund of tax paid in relation to discounted ESS interests in certain circumstances where those interests are forfeited and the employee has been taxed on the discount.

1.60 These provisions provide a refund of tax in circumstances where the employee had no choice but to forfeit the ESS interest, and where the conditions of the scheme were not constructed to protect the employee from market risk.

1.61 Under such circumstances, the forfeited ESS interest is treated as never having been acquired, and the taxpayer can claim a refund of income tax by amending their assessment to remove income previously included in their assessable income. There is no time limit on amending an assessment to exclude an amount from a taxpayer’s assessable income for a share interest which is forfeited, or for a right which was lost without being exercised.

1.62 As the refund provisions are not intended to protect the employee from downside market risk, a refund will not be available where the share interest is forfeited only because the value of the securities has fallen due to market losses.

**Comparison of key features of new law and current law**

<i>New law</i>	<i>Current law</i>
<p>Upfront taxation is the default position.</p> <p>Deferral of tax will be limited to schemes which:</p> <ul style="list-style-type: none"> <li>• require that any benefits provided are at real risk of forfeiture and meet certain other conditions; or</li> <li>• are provided through a salary sacrifice arrangement offering no more than \$5,000 worth of benefits to an employee, and where               <ul style="list-style-type: none"> <li>– there is no real risk of forfeiture; and</li> <li>– the rules of the scheme explicitly state that tax will be deferred; and</li> </ul> </li> </ul>	<p>Upfront taxation is the default position.</p> <p>An employee participating in a qualifying scheme can, subject to certain conditions, choose to defer tax or pay tax upfront.</p>

<i>New law</i>	<i>Current law</i>
– meet certain other conditions.	
Eligibility for the upfront or deferred tax concession is based on the characteristics of the employee share scheme.	An employee is eligible for the upfront or deferred tax concession if they acquire ‘qualifying’ shares or rights.
Employees with a taxable income (after adjustments) of less than \$180,000 will receive the upfront concession and not pay tax on the first \$1,000 of discounts received, if the scheme meets certain conditions.	Employees in a qualifying scheme can elect to be taxed upfront and not pay tax on the first \$1,000 of discounts received. There is no means testing.
In schemes where the tax is deferred, the taxing point is the earliest of: <ul style="list-style-type: none"> <li>• when there is no risk of forfeiture of the benefits and any restrictions on the sale or exercise are lifted;</li> <li>• when the employee ceases employment; or</li> <li>• seven years after the shares or rights were acquired.</li> </ul>	Where an employee has chosen to defer tax, the taxing point is the earliest of: <ul style="list-style-type: none"> <li>• when restrictions on sale are lifted;</li> <li>• when the employee sells the shares or exercises the options;</li> <li>• when the employee ceases employment; or</li> <li>• ten years after the shares or rights were acquired.</li> </ul> There is no upfront concession if the tax deferral is chosen.
An employee is eligible for a refund of tax on forfeited shares and rights if the forfeiture was not the result of: <ul style="list-style-type: none"> <li>• a choice of the employee; or</li> <li>• a condition of the scheme that protects the employee against a fall in market value.</li> </ul>	An employee is eligible for a refund of tax on forfeited rights only (not shares).  The refund is available if the employee loses the right without having exercised it.
Employers are subject to annual reporting requirements.	No equivalent.
A limited form of withholding tax will be introduced in cases where an employee fails to provide their employer with a TFN or ABN.	No equivalent.

## Detailed explanation of new law

1.63 This Schedule reforms the taxation of employee share schemes. It also rewrites Division 13A from the ITAA 1936 into Division 83A of the ITAA 1997.

1.64 Rewriting the existing provisions into the ITAA 1997 provides an opportunity to simplify and improve the readability of the provisions.

1.65 References in this explanation are to the ITAA 1997 unless otherwise stated.

## Objects of taxing employee share schemes

1.66 An *employee share scheme* provides employees with a financial interest in the company they work for through the distribution of shares in that company. [Schedule 1, item 1, subsection 83A-10(2)]

1.67 An *ESS interest* is a beneficial interest in a share in a company; or a right to acquire a beneficial interest in a share in a company. [Schedule 1, item 1, subsection 83A-10 (1)]

1.68 Any discount that the employee receives by acquiring an ESS interest below the market price is a benefit relating to employment, similar to salary or wages, and so would usually be considered income of the employee. These amendments tax the value of that discount, to ensure employees are taxed consistently regardless of the forms of remuneration they receive.

1.69 However, the employee share scheme tax rules also specifically aim to improve the alignment of employee and employer interests.

1.70 In recognition of the economic benefits derived from employee share scheme arrangements, the rules provide for tax concessions for employees participating in employee share schemes.

1.71 Tax support is provided on the grounds that aligning the interests of employees and employers encourages positive working relationships, boosts productivity through greater employee involvement in the business, reduces staff turnover and encourages good corporate governance. [Schedule 1, item 1, paragraph 83A-5(1)]

1.72 Taxing discounts in the income tax system means that the employee pays tax on the discount at their marginal tax rate. If this was not the case, the discount would instead be subject to fringe benefits tax, which may be at a higher rate.

1.73 Employees who pay tax upfront may receive an upfront tax concession. The upfront tax concession reduces the amount of a discount that an employee pays tax on, if they are a low or middle income earner and the scheme meets certain conditions (see paragraphs 1.83 to 1.100).

1.74 Alternatively, employees may receive a tax concession in the form of a deferral of tax. The schemes must meet certain conditions for the employee to defer tax on any discount to a later period (see paragraphs 1.101 to 1.146).

### **Upfront taxation (inclusion of discount in assessable income on acquisition)**

#### *Upfront taxation is the default position*

1.75 Generally, any discount to the market value of ESS interests in shares or rights provided under an employee share scheme is taxed upfront on acquisition. That means that the market value of the discount must be included in an employee's assessable income for that income year. [Schedule 1, item 1, subsection 83A-25 (1)]

#### **Example 1.1: Inclusion of a discount in assessable income**

Liz is employed by Pink Boats Inc. She receives \$100,000 worth of Pink Boat shares for \$50,000 under an employee share scheme. This means that she has received a discount of \$50,000, which will be included in her assessable income upon her acquisition of the ESS interests.

1.76 Interests provided under an employee share scheme will be taxed upfront unless the interest was acquired through a scheme that meets the conditions for deferred taxation; or the interest has already been taxed under the employee share scheme rules. For example, an employee may acquire an interest that has already been taxed if they exercise a right to acquire a share that was already subject to tax under the ESS rules. In this situation they should not be taxed twice, simply because they have undertaken a multi-step process to acquire the share. [Schedule 1, item 1, section 83A-20]

1.77 Consistent with the treatment of most other types of income, whether an amount is included in a taxpayer's assessable income under the new ESS rules will depend on the taxpayer's residency status and the source of the income (see paragraphs 1.246 to 1.263).

#### *Market value*

1.78 The ordinary meaning of market value is used for determining the market value of ESS interests.

1.79 The ordinary meaning of market value is used for almost all other tax purposes, and the increased flexibility that this provides means that taxpayers are able to choose a valuation methodology that fits their circumstances and has the lowest compliance costs associated with it. The ATO publishes material on working out market value which can be found in the ATO's guide *Market value for tax purposes*.

1.80 The valuation rules in the current law are inflexible and often result in overly high compliance costs for taxpayers, particularly those with unlisted shares. However, taxpayers could continue to apply the existing detailed methodologies in the current employee share scheme rules as these would fall within the scope of those methodologies the ATO currently considers acceptable under the general rules (with the exception of the rules for valuing unlisted rights as explained below).

1.81 However, alternative methods of calculating the value of an interest can be specified by regulation in the *Income Tax Assessment Regulations 1997* (the Regulations). The Government proposes that the existing rules in relation to unlisted rights be replicated in the Regulations as an interim measure until the Board of Taxation completes its review on how best to determine the market value of employee share scheme benefits. Taxpayers can use these rules (as the interim measure) or opt to use the general market valuation rules if they so choose.

1.82 The general valuation rules for unlisted shares mean that taxpayers will no longer be obliged to use an auditor if they can determine (and sufficiently justify) the market value appropriately without one.

#### ***The upfront tax concession***

1.83 The upfront concession provides that an employee does not include a discount on an ESS interest in their assessable income if the value of discount is \$1,000 or less. If the discount is greater than \$1,000, they may reduce the amount they include in their assessable income by \$1,000 (meaning they are assessed on the excess over \$1,000). [*Schedule 1, item 1, subsection 83A-35(1)*]

1.84 Employees who pay tax upfront may receive the upfront tax concession, if they are low or middle income earners and the employee and the scheme must meet a number of conditions. [*Schedule 1, item 1, section 83A-35*]

#### ***Income test***

1.85 The new law introduces an income test for the upfront concession to restrict eligibility to low and middle income earners.

1.86 Employees are not eligible for the upfront concession if their taxable income for the year, after adjustments, is greater than \$180,000. [Schedule 1, item 1, paragraph 83A-35(2)]

1.87 Taxable income is adjusted by adding an employee's reportable fringe benefits, reportable superannuation contributions and total net investment loss for the year [Schedule 1, item 1, paragraph 83A-35(2)]. This ensures that the test uses a more complete calculation of an individual's income than taxable income alone.

### **Example 1.2: Employee is eligible for upfront concession**

Matt is employed by Apple Bank Pty Ltd, and acquires shares in Apple Bank at a \$1,500 discount to their market value under an employee share scheme. The scheme is not eligible for deferral.

When the Commissioner assesses Matt's income tax for the year, his taxable income adjusted by reportable fringe benefits, reportable superannuation contributions and total net investment loss is \$80,000 (this calculation disregards any application of the upfront discount).

If Matt and Apple Bank's scheme meets the other conditions, Matt will receive the upfront concession, and will reduce the amount of the discount included in his assessable income by \$1,000. He will still include the remaining \$500 in his assessable income.

### **Example 1.3: Employee is not eligible for upfront concession**

Liam is employed by Starstruck Co, and acquires shares in Starstruck Co at a \$1,000 discount to their market value through an employee share scheme. The scheme is not eligible for deferral.

When the Commissioner assesses Liam's income tax for the year, his taxable income adjusted by reportable fringe benefits, reportable superannuation contributions and total net investment loss is \$200,000.

Although Liam and Starstruck Co's scheme may meet the other conditions to access the upfront concession, Liam's income is too high to receive the upfront concession. He must include the full amount of the discount in his assessable income for that year.

#### *Must be employed*

1.88 The upfront concession is only available if, at the time of acquiring the interest, the employee is employed by the company offering the scheme, or one of its subsidiaries. [Schedule 1, item 1, subsection 83A-35(3)]

1.89 This is so that the concession only applies in situations where there is the necessary employment relationship.

*Scheme must relate to ordinary shares*

1.90 The ESS interests offered under the scheme must relate to ordinary shares [*Schedule 1, item 1, subsection 83A-35(4)*]. This is because shares that are not ordinary shares, such as preference shares, may have less ‘risk’ associated with them. For example, they may pay a more stable income stream or have priority over ordinary shares in the event of bankruptcy. They are therefore less likely to align the shareholder’s interest with that of the company.

*Scheme must be non-discriminatory*

1.91 To encourage the wide availability of employee share schemes and the associated productivity benefits, the scheme must be non-discriminatory. This means that the scheme must be available to at least 75 per cent of permanent employees of the employer. [*Schedule 1, item 1, subsection 83A-35(6)*]

1.92 While this requirement is to encourage schemes to be available as widely as possible, the scheme is only required to be offered to *permanent* employees, and only to *75 per cent* of permanent employees, because it may be difficult in practice to offer the scheme to all employees or to casual employees.

*Shares or rights provided must not be at real risk of forfeiture*

1.93 The ESS interests provided through the scheme must not be at real risk of forfeiture. [*Schedule 1, item 1, subsection 83A-35(7)*]

1.94 An ESS interest is at real risk of forfeiture if a reasonable person would consider that there is a real risk that the employee would lose the interest, or never receive it, other than by selling or exercising it, or through the market value of the ESS interest falling to nil. For more discussion of real risk of forfeiture, see paragraphs 1.118 to 1.127.

1.95 It is considered appropriate for tax to be deferred on ESS interests that the employee may never in fact receive.

*Minimum holding period*

1.96 The law requires the interest to be held for a minimum period to ensure that the concession is only provided where there is sufficiently lengthy alignment of interests between the employee and employer. If the minimum holding period were not in place an employee could access the upfront tax concession, effectively receiving \$1,000 in untaxed remuneration, and immediately sell the ESS interest for cash. This is not consistent with the intended aim of offering the tax concession in order to align employee and employer interests.

1.97 The ESS interest provided cannot be disposed of for three years, unless the employee ceases to be employed at an earlier time [*Schedule 1, item 1, subsection 83A-35(8)*]. An employee is considered to have ceased employment when they are no longer employed either by their employer, a holding company of their employer, or a subsidiary of either of them [*Schedule 1, item 1, section 83A-330*].

*Employee must not have significant ownership or voting rights*

1.98 The interest provided to an employee must not result in the employee having effective ownership of greater than 5 per cent of their employer, and not controlling more than 5 per cent of the maximum voting rights in the employer. [*Schedule 1, item 1, subsection 83A-25(9)*]

1.99 This provision encourages the benefits of the employee share scheme to be spread widely among employees. The concession is intended to encourage employees with small or no ownership in their employer to take up an interest in the company. It is considered that if one employee owns more than 5 per cent of the voting rights, interests between the company and that shareholder are already aligned, and no tax concession is appropriate.

1.100 Further, this also acts as an integrity rule that prevents taxpayers from misapplying the concession in order to buy a business or indirectly access company profits through the employee share scheme rules. The concession is intended to apply in respect of the employee/employer relationship and not in relation to the company/shareholder relationship.

## **Deferred taxation (the deferred inclusion of a gain in assessable income)**

### *Deferred taxation options*

1.101 Although 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 upfront in the same manner, exceptions to this general principle are made for two forms of employee share scheme – schemes where the ESS interests are at real risk of forfeiture, and schemes where the ESS interests are acquired under a salary sacrifice arrangement.

1.102 Unlike the current law, whether a share or right is subject to taxation upfront or at a later time now depends on the structure of the scheme and not an election of the employee. This reduces the tax avoidance problems associated with the existing election arrangements and reduces compliance costs, because the employer can advise the employee of the taxation arrangements applying to that scheme.

1.103 Removing the election also makes it easier for employers to comply with the new reporting requirements (see paragraphs 1.215 to 1.228) and for the ATO to monitor the new arrangements.

1.104 For the deferred tax rules to apply, the relevant ESS interests must be acquired at a discount under an employee share scheme, the ESS interest must relate to ordinary shares and be subject to a real risk of forfeiture (see paragraphs 1.118 to 1.127 for discussion of real risk of forfeiture). *[Schedule 1, item 1, section 83A-105]*

1.105 In addition, a share, right or stapled security you acquire under salary sacrifice arrangements can also be subject to this deferred taxing point if the employee gets no more than \$5,000 worth of shares under those arrangements in an income year. *[Schedule 1, item 1, subsection 83A-105(4)]*

1.106 Under the deferral case, any gain is included in assessable income in the first income year it is possible to dispose or exercise of the share, right or security. If employment ceases earlier, or if 7 years pass, the gain is included in that income year instead. *[Schedule 1, item 1, section 83A-115]*

1.107 The upfront taxation rules do not apply if an ESS interest qualifies for deferred taxation. *[Schedule 1, item 1, subsection 83A-105(1)].*

1.108 The deferral rules also do not apply to a share acquired by exercising a right that was acquired under an employee share scheme for reasons outlined in paragraph 1.76. *[Schedule 1, item 1, paragraph 83A-105(1)(a)]*

1.109 Further, for deferred taxation to apply, the scheme which the ESS interest is acquired under must also meet a number of conditions (see paragraphs 1.101 to 1.146 for a more detailed explanation).

***Amount to be included in assessable income***

1.110 Whereas the upfront taxation of an ESS interest makes the full amount of any discount received on shares or rights assessable in the income year in which it is acquired, under deferred tax arrangements, an amount is included in assessable income for the income year to which the deferred taxation point occurs is calculated as the market value of the interest at the deferred taxing point reduced by the cost base of the interest. *[Schedule 1, item 1, subsection 83A-110(1)]*

1.111 Consistent with the treatment of most other types of income, whether an amount is included in a taxpayer's assessable income under the new ESS rules will depend on the taxpayer's residency status and the

source of the income (see paragraphs 1.246 to 1.263). [*Schedule 1, item 1, subsection 83A-110(2)*]

### ***Calculating the value of shares at the taxing point***

#### *Market value*

1.112 The measure uses the ordinary meaning for determining market value for shares and rights (refer to paragraphs 1.78 to 1.82).

#### *Cost base*

1.113 The current law calculates the amount of assessable income as market value less consideration paid or given.

1.114 The existing use of consideration does not take into account such things as interest and brokerage fees that would alter the cost base.

1.115 By using consideration paid or given, events such as value shifting, a return or capital or other expenses incurred in holding the asset are not taken into account.

1.116 Currently, by using consideration as the cost and resetting the cost base of the share after the deferred taxation point, any change in the value of the ESS interest due to these events (such as a return of capital) is not picked up in the value.

1.117 The concept of cost base takes into account these events is a more appropriate base on which to calculate the discount and gains on the interest up to the taxing point.

### ***ESS interests at real risk of forfeiture***

1.118 In situations where there is a real risk that the benefits of shares or rights are never realised because the ESS interests are forfeited, deferral of taxation is considered the appropriate treatment.

1.119 Providing for the deferral of tax in these situations recognises that the employee may never have a chance to recognise the economic value of the ESS interest, and that having employee remuneration ‘at risk’ in this manner is entirely consistent with the purpose of concessional taxation of employee share schemes, namely to align the interests of employees and employers.

1.120 The measure provides that if an ESS interest is at real risk of forfeiture, and the scheme meets the other conditions outlined in the rules, taxation will be deferred until the ESS deferred taxing point (see paragraphs 1.147 to 1.159 for discussion of the ESS deferred taxing point).

*The real risk of forfeiture test*

1.121 To defer tax in the real risk of forfeiture case:

- in the case of a share, there must be a real risk under the conditions of the scheme that the employee will lose the share other than by disposing of it; or
- in the case of a right to acquire a beneficial interest in a share:
  - there must be a real risk that, under the conditions of the scheme, the employee will lose the right other than by disposing of it, exercising it or letting it lapse; or
  - there must be a real risk that, under the conditions of the scheme, if the employee exercises the right to get a beneficial interest in a share, they will lose the beneficial interest in the share other than by disposing of it.

*[Schedule 1, item 1, subsection 83A-105(3)]*

1.122 Under the ‘real risk of forfeiture test’, ‘real’ is regarded as more than a mere possibility. Something is not a real risk if a reasonable person would disregard risk as highly unlikely to occur or is nothing more than a rare eventuality or possibility.

1.123 The ‘real risk of forfeiture’ test does not require employers to provide schemes in which their employee share scheme benefits are at a significant or substantial risk of being lost.

1.124 Rather, it is intended to stop schemes which contrive to defer tax without complying with the intent of the proposed law, and to provide for deferral of tax when there is a real incentive to the employee through having their benefits at risk. This is consistent with the policy rationale for the concessional tax treatment of employee share scheme arrangements.

1.125 For the risk to be a real risk of forfeiture it must be a real risk; contrived schemes, where the risk is highly unlikely to arise, will not qualify.

**Example 1.4: Contrived risks**

‘Your shares are forfeited if the company’s value falls by 95 per cent during the next 12 months’ or ‘your shares are forfeited if you request they be forfeited’ are not real risks.

1.126 Real risk includes situations in which a share or right is subject to meaningful performance hurdles or the securities will be forfeited if a minimum term of employment is not completed.

1.127 However, a condition that merely restricts an employee from disposing of a share or right for a specified time carries with it no real risk of forfeiture.

**Example 1.5: Forfeiture on cessation of employment**

Matt enters an ESS arrangement with his employer, XYZ Ltd. He will receive 1,000 XYZ shares in three years, if he is still employed by Pinder Ltd at that time.

*Real risk of forfeiture?:* Yes, Matt's shares are at risk and he will defer tax for three years.

**Example 1.6: Forfeiture on cessation of employment – a different test**

Suzy enters into an ESS arrangement with her employer, AAA. She will receive 1,000 AAA shares in three years, if she is still employed by AAA at that time.

Further, Firm AAA will grant her shares if she ceases employment before three years for an unexpected reason, such as sickness, invalidity under a 'good leaver clause'.

*Real risk of forfeiture?:* Yes, Suzy's shares are at risk and she will defer tax for three years. However, if employees at Firm AAA routinely received their shares regardless of their reason for leaving, the ATO may consider that the scheme has contrived a 'real risk' and not eligible for deferral of tax.

**Example 1.7: Fraud or gross misconduct**

Joe enters into an ESS arrangement with his employer, SAS. He will receive 1,000 SAS shares in three years, unless he is dismissed for fraud or gross misconduct.

*Real risk of forfeiture?:* No, Joe's shares are not at any real risk. A reasonable person would not consider there to be a real risk of forfeiture in relation to the scheme.

**Example 1.8: Performance hurdles**

Amy enters into an ESS arrangement with her employer, PPP. She will receive 1,000 PPP shares in one year, if PPP's market share has increased in 12 months time.

*Real risk of forfeiture?:* Yes, Amy's shares are at risk and she will defer tax for the year.

**Example 1.9: Performance hurdles over a portion of ESS benefits**

Brad enters into an ESS arrangement with his employer, GRR. He will receive 1,000 GRR shares in one year if GRR's market share increases over the year, and 500 GRR shares in one year if it does not.

*Real risk of forfeiture?:* Yes, but only in respect of 500 shares. 500 of Brad's shares are at risk and he will defer tax on these for the year. However, Brad's other 500 shares are not at risk, and he will pay tax upfront on these.

*Scheme must relate to ordinary shares*

1.128 The shares or rights offered under the scheme must relate to ordinary shares. [*Schedule 1, item 1, subparagraph 83A-105(1)(b)*]

1.129 Deferred taxation is restricted to interests over ordinary shares to encourage the alignment of employee and employer interests. ESS interests that are not ordinary shares, such as preference shares, may have less 'risk' associated with them because they pay a more stable income stream and have priority over ordinary shares if the company winds up. They are therefore less likely to align the shareholder's interest with that of the company.

*Scheme must be non-discriminatory (in respect of shares)*

1.130 The employer must offer a scheme or schemes that are available to at least 75 per cent of the permanent employees of the company. This means over all the schemes that the employer offers, more than 75% of permanent employees must be able to access shares under at least one of those schemes. [*Schedule 1, item 1, subsection 83A-105(2)*]

1.131 This requirement does not apply to schemes that offer only rights to acquire a share, rather than shares.

1.132 While this requirement is to encourage schemes to be available as widely as possible, the scheme or group of schemes offered by an employer are only required to be offered to *permanent* employees, and only to 75 per cent of permanent employees, because it may be difficult in practice to offer the scheme to all employees or to casual employees.

*Employee must not have significant ownership or voting rights*

1.133 The interest provided to an employee must not result in the employee having effective ownership of greater than 5 per cent of their

employer, and not controlling more than 5 per cent of the maximum voting rights in the employer. [*Schedule 1, item 1, paragraph 83A-105(1)(b)*]

1.134 This provision encourages the benefits of the employee share scheme to be spread widely among employees. The concession is intended to encourage employees with small or no ownership in their employer to take up an interest in the company. It is considered that if one employee owns more than 5 per cent of the voting rights, interests between the company and that shareholder are already aligned, and no tax concession is appropriate.

1.135 Further, this also acts as an integrity rule that prevents taxpayers from misapplying the concession in order to buy a business or indirectly access company profits through the employee share scheme rules. The concession is intended to apply in respect of the employee/employer relationship and not in relation to the company/shareholder relationship.

*ESS interests provided through a salary sacrifice scheme*

1.136 The deferral arrangements also allow for ESS interests received at a discount through a salary sacrifice arrangement to be subject to deferred taxing treatment if the salary sacrifice arrangement is part of the employee's remuneration package, in circumstances where it is reasonable to conclude that the salary or wages would be greater if the interest was not made part of that package. The risk of forfeiture is not necessary to get deferred taxation treatment through a salary sacrifice scheme.

1.137 Providing for deferred tax in the case of employee share schemes involving salary sacrifice arrangements ensures that employees utilising similar arrangements under the existing law will continue to be able to access these arrangements with minimal disruption. This encourages the broad availability of, and participation in, employee share schemes, and the broad alignment of the interests of employees and employers in Australia.

1.138 It also ensures the schemes are aimed at low to middle income earners by limiting the ability to salary sacrifice such arrangements and remain eligible to defer the taxing point.

*ESS interest must be acquired solely under salary sacrifice arrangements*

1.139 For tax to be deferred under the 'salary sacrifice case', the ESS interest must be provided:

- because the employee agreed to acquire the interest in return for a reduction in salary or wages that would not have happened apart from the agreement; or

- as part of the remuneration package, in circumstances where it is reasonable to conclude that the employee's salary or wages would be greater if the interest was not part of that package.

*[Schedule 1, item 1, paragraph 83A-105(4)(a)]*

1.140 In order for deferred tax treatment to apply, the employee must receive the shares, under the salary sacrifice arrangement, for no consideration payment. That is, the discount per share provided through the arrangement is equal to the market value of the share. *[Schedule 1, item 1, paragraph 83A-105(4)(b)]*

*Governing rules of the scheme must state that deferred taxation applies to the scheme*

1.141 For tax to be deferred under the 'salary sacrifice case', the governing rules of the scheme must expressly state that the deferred taxation arrangement applies to the taxation of the scheme. *[Schedule 1, item 1, subparagraph 83A-105(4)(b)(iii)]*

1.142 This requirement is to clearly differentiate the scheme from similar salary sacrifice schemes, which are not intended to be subject to the deferred taxation arrangements.

*ESS interests acquired must not exceed \$5,000 per annum*

1.143 The total market value of the ESS interests acquired during an income tax year must not exceed \$5,000, based on the market value of each interest, at the time the interest is acquired. *[Schedule 1, item 1, paragraph 83A-105(4)(c)]*

1.144 The \$5,000 limit is allowed per employee per employment relationship. However, employees with more than one employment relationship within a particular corporate group cannot access the \$5,000 cap twice.

#### **Example 1.10**

During the same tax year, Allan worked in three shops – X, Y and P. Shops X and Y are part of the same corporate group, as they belong to the same holding company. Allan would be able access deferred tax treatment for any shares he acquired through a salary sacrifice arrangement as part of his remuneration package for \$5,000 combined between shops X and Y, and a further \$5,000 worth from company P, as it is unrelated to the holding company for shops X and Y.

1.145 This requirement ensures that deferral of tax is only provided for in a targeted manner for low and middle income earners.

1.146 The scheme must also meet the requirements by relating to ordinary shares, be non-discriminatory and no employee must receive ownership rights greater than 5 per cent, as explained in paragraphs 1.128 to 1.135.

***The ESS deferred taxing point***

1.147 When tax on an employee share scheme discount is deferred, it is deferred until the ESS deferred taxing point occurs.

*ESS deferred taxing point for shares*

1.148 The deferred taxing point for shares is the earliest of:

- the earliest time when:
  - there is no real risk that the employee will lose the share under the conditions of the scheme other than by disposing of it; and
  - there are no restrictions preventing disposal,
- when the employee ceases the employment in respect of which they acquired the share; or
- 7 years after the employee acquired the share.

*[Schedule 1, item 1, subsection 83A-115(1)]*

1.149 Restrictions preventing disposal are considered to be lifted once an opportunity arises in which a taxpayer can dispose of the share.

1.150 In the case of a trading window, to the extent that restrictions may lift and then re-engage, if the taxpayer does not avail themselves of the opportunity to dispose of the share and the window subsequently closes, there is no further delay in the taxing point. The taxing point would still be at the commencement of the first trading window.

1.151 The limited deferral period is aimed at ensuring fairness, aligning interests between the employer and employee, and preserving the integrity of the tax system by preventing unlimited deferral of tax on significant remuneration.

1.152 The insider trading laws and a company's share trading policy are not considered to be restrictions for the purposes of deferring the taxing point. There needs to be a legal barrier to the disposal of the share or right which the insider trading laws do not create. Those laws do not

legally prevent the disposal of shares or rights, they merely penalise those that dispose of shares or rights in particular circumstances.

1.153 However, if restrictions are included in share plans that legally prevent disposal of shares in case that result in a breach of the insider trading laws, this would be sufficient to constitute a restriction.

1.154 The restriction and conditions covered by the deferred taxing points are only those that existed when the employee acquired the ESS interest. Conditions and restrictions that have been added subsequent to acquisition are ignored for the purposes for determining the deferred taxing point.

*ESS deferred taxing point for rights*

1.155 The deferred taxing point for rights is the earliest of:

- the earliest time when:
  - there is no real risk that, under the conditions of the scheme, the right will be lost in any way other than by disposing of it, exercising it, or letting it lapse without exercising it; and
  - if, when the right was acquired, restrictions preventing the taxpayer from immediately disposing of the right, the scheme no longer restricts this;
- the earliest time when:
  - there is no real risk that, under the conditions of the scheme, the right will be lost in any way other than by disposing of it, exercising it, or letting it lapse without exercising it; and
  - if, when the share was acquired, restrictions prevented immediately exercising the right, the scheme no longer restricts this; and
  - there is no real risk that, under the conditions of the scheme, if the right is exercised, the beneficial interest in the share will be lost in any way other than by disposing of it; and
  - if, when the share was acquired, restrictions prevented immediate disposal of the beneficial interest in the share if

the right was exercised, the scheme no longer restricts this.

- when the employee ceases the employment in respect of which they acquired the share; or
- 7 years after the employee acquired the share.

*[Schedule 1, item 1, subsection 83A-115(3)]*

1.156 The current rules for the taxing point for rights are subject to additional concessionality (by way of a longer deferral period) and are therefore open to greater abuse from those wishing to artificially defer the taxing point. Bringing the taxing points for rights into closer alignment with shares will ensure that taxpayers cannot seek to undermine the integrity changes proposed to the refund rules.

1.157 The taxing point is the point at which the taxpayer can take some action to realise the benefit. It does not matter whether or not they chose to.

1.158 The ESS deferred taxing point for the ESS interest is moved to the time you dispose of the interest if that is within 30 days after the original deferred taxing point. *[Schedule 1, item 1, subsections 83A-115(2) and (4)]*

1.159 This will make compliance easier by avoiding unnecessary valuation and the application of multiple taxing regimes.

#### ***Re-acquisition of share or right (transfer to CGT system)***

1.160 The new law ensures that the cost of the share or right is reset to market value on the day after the deferred taxing point for purposes of the other regimes (e.g. CGT trading stock). Acquisition time also resets. *[Schedule 1, item 1, section 83A-125]*

1.161 This is to ensure that, once the asset falls outside of the employee share scheme provisions, there is no double taxation in relation to the shares or rights, and the share become taxable in the same manner as a share acquired on the market.

#### **Example 1.11**

Toby participates in an employee share scheme run by his employer. He received \$2,000 worth of shares for \$1,500. As there is a genuine risk of forfeiture, taxation on the shares was deferred.

At the taxing point (seven years after he acquired the interest) relating to the employee share scheme he participated in, Toby's shares were

valued at \$3,000. Any increase in the value of these shares plus any discount he was given when he received the shares would be taxable as income in that income year. His income includes \$1,500 under the ESS rules.

The market value of the shares is now used as the cost base for Toby. If he were to sell his shares ten months later for \$3,200, he would have a capital gain of \$200 and would not be eligible to receive the CGT discount of 50 per cent since he has held the shares for less an one year.

If the shares' cost base were not reset to their market value at the deferred taxation point, Toby would instead have had a capital gain of \$1,700 and have faced double taxation on the first \$1,500 of the gain.

## **Takeovers and restructures**

1.162 The rules ensure that employees are not adversely affected by takeovers and restructures by allowing taxpayers who have deferred the income tax liability on a discount received on shares or rights acquired under an employee share scheme to roll-over a taxing point that would otherwise occur because of a corporate restructure.

1.163 Since there are situations where employees may defer their income tax liability arising from a discount on shares or rights, a corporate restructure may give rise to a deferred taxing point by triggering a disposal of the shares or rights or by breaking the employment relationship between an employee and the company that originally granted the shares or rights. This would not be the intended outcome.

1.164 The new rules ensure this is not the case by allowing the employee share scheme rules to still apply if an arrangement is entered into that is intended to result in the original existing company in becoming the full subsidiary of another company or the there is a change in the ownership of the existing company that results in any ESS interests in the old company being replaced, whole or partly, by ESS interests in one or more other companies. *[Schedule 1, item 1, section 83A-125]*

1.165 This works by treating the shares or rights in the new company that match the shares or rights in the old company as a continuation of the shares or rights in the old company that they are matching, and treating the employment in the new company as a continuation of the employment in the old company.

1.166 The roll-over relief will not apply to deferred taxing points that occur outside of corporate restructures.

1.167 A taxing point will still arise when an employee's employment ceases with the employer, when the disposal restrictions expire or the 7 year maximum tax deferral period from the date the rights or shares were acquired expire, whichever event occurs first.

1.168 The idea of roll-over relief for corporate takeovers and restructures was introduced and explained in detail in the Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2005.

*Treat new interests as continuations of old interests*

1.169 The new interests in the new company that are acquired in connection with the takeover or restructure that relate to ordinary shares are treated as a continuation of the original ESS interests. [*Schedule 1, item 1, subsection 83A-125(2)*]

1.170 This only applies to the extent that as a result of the arrangement or change, the employee stops holding the old interests and the new interests can reasonably be regarded as matching any of the old interests. [*Schedule 1, item 1, paragraph 83A-125(2)(b)*]

1.171 When considering to what extent something can reasonably be regarded as matching any of the old interests, one of the factors to consider is the respective market values of that thing and of the old interests.

1.172 Matching shares or rights are the replacement shares or rights provided to put the employee in the same position financially after the corporate restructure as before it. Matching shares or rights should be no more than that which is required to place the employee in the same position financially as if the restructure had not occurred.

1.173 The relief is limited to matching shares so that the taxpayer does not receive any additional benefit as a result of the restructure than he or she would otherwise have received.

1.174 It must be possible to identify the shares or rights that the employee holds as a result of the restructure and they must reasonably match the employee's original holding of shares or rights immediately before the restructure.

**Example 1.12: Matching the value of shares**

Fred acquired 100 shares at a discount under an ESS in Company A in 1999 and deferred his tax liability on the discount. In 2004, Company A shares are valued at \$0.50 per share. Following an announcement of a takeover by Company B, the price of Company A shares increases to \$1. Company B buys out all shares in Company A.

Fred's shares are replaced by 200 Company B shares valued at \$0.50 per share. Following the restructure, Fred is employed by Company B. The shares in Company B are matching for the purposes of the roll-over, as they have the same value as the original shares in Company A. (This example assumes no shifting in value from non-ESS interests to ESS interests.)

1.175 While the taxpayer should not receive any additional benefit, there need not be a one to one ratio between the old and the new shares or rights in order for them to be matching, provided that the value of the new shares or rights relative to the old shares or rights remains unchanged.

Stanley acquires 200 shares under an ESS in Streetcar Pty Ltd. Busline Pty Ltd then buys out all shares in Streetcar Pty Ltd on the basis of two shares in Busline Pty Ltd for each share held in Streetcar Pty Ltd. As a result of the takeover, Stanley is issued 500 shares in Busline Pty Ltd. He receives 400 shares in exchange for his 200 shares and a further 100 shares by way of an employee bonus. The matching shares are the 400 shares in Busline Pty Ltd. The additional 100 shares that Stanley received are over and above what is required to put him in the same position financially after the restructure as before it. The 400 shares Stanley holds in Busline Pty Ltd are matching for the purpose of accessing the roll-over relief, as these shares have the same value as the old shares. (This example assumes no shifting in value from non-ESS interests to ESS interests.)

1.176 To be matching, the market value of the original shares or rights immediately before the restructure (or a reasonable estimate of the market value of the shares or rights) should be the same or equivalent to the value of the replacement shares or rights as a result of the restructure.

Marian acquires 1,000 shares in Pebbles Inc as part of an ESS. Immediately prior to a takeover by Granite Pty Ltd, the shares have a market value of \$1 per share. Granite Pty Ltd acquires all shares in Pebbles Inc and gives shareholders two shares in Granite Pty Ltd for one share in Pebbles Inc. As replacement for her shares in Pebbles Inc, Marian was given 1,600 shares in Granite Pty Ltd and \$800 in cash. The market value of the replacement share package after the restructure exceeds the value of her old shares by \$600. The \$600 was by way of an employee bonus. The 1,600 shares in Granite Pty Ltd and only \$200 (of the \$800) 'match' the original shares, as they are similar in value to the shares held by Marian prior to the takeover. Marian has acquired interests as a result of the restructure that exceed the value of her old shares worth \$600. (This example assumes no shifting in value from non-ESS shares to ESS shares.)

1.177 The replacement of old shares or rights with an equivalent combination of new shares and cash is considered to be matching. Where some additional benefit is received as part of the replacement of the shares and rights in the old company following a restructure, the additional

benefit is not matching. However, a deferred taxing point will arise to the extent that the old shares or rights are replaced by cash that is matching, as roll-over relief only applies to matching shares or rights that are treated as a continuation of the shares or rights in the old company.

1.178 To be regarded as reasonably matching, the attributes of the shares or rights immediately before the restructure need to be the same, or substantially the same, immediately after the restructure. Attributes include whether it is a share or a right. The replacement of shares for rights, or vice versa, following a restructure would not qualify for roll-over relief as the essential characteristic of the employee's interests (shares or rights) provided after the restructure would have substantially changed.

1.179 The tax treatment of non-matching shares or rights immediately after a corporate restructure will be determined on the basis of the application of the base employee share scheme rules and will depend on the circumstances in each case.

1.180 Treating the matching shares or rights as a continuation of the shares or rights in the old company means that the replacement of shares or rights is not treated as a disposal of the shares or rights in the old company or as an acquisition of shares or rights in the new company.

**Example 1.13: Continuation of shares or rights**

Using the scenario in *Example 1.12* above, following the restructure, Fred is employed by Company B. As Fred also holds replacement shares in Company B that match the value of the shares in Company A, the replacement shares he gets in Company B are deemed to be a continuation of the shares in Company A for the purpose of the roll-over.

1.181 Where a taxpayer holds shares or rights in the old company that were acquired at different times, the matching shares or rights are also held to be acquired at those different times. The 7 year maximum deferral period will continue to run from the date the original shares or rights were acquired.

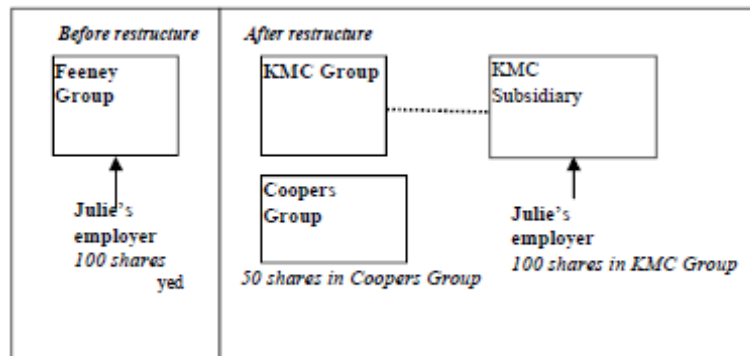
Rob acquires 100 shares in Island Pty Ltd under an employee share scheme in the year 2000 and acquires a further 100 shares in 2002. Friday Pty Ltd acquires all the shares in Island Pty Ltd and gives all shareholders one share in Friday Pty Ltd for each share held in Island Pty Ltd. Rob now holds 200 shares in Friday Pty Ltd, 100 of which will face a maximum period of deferred taxation by 2007 and 100 of which will face a maximum period of deferred taxation by 2009.

*Old interest not matched by new interests*

1.182 The old interests can be considered to have been disposed of to (in connection with the takeover or restructure) if they can reasonably be regarded as matching any of the old interests but do not meet the criteria to be considered a continuation of those interests. [Schedule 1, item 1, subsection 83A-125(4)]

1.183 Employment in the new company, a subsidiary of the new company; a holding company (within the meaning of the *Corporations Act 2001*) of the new company; or a subsidiary of a holding company of the new company is to be treated as a continuation of the employment in respect of which the old interests were acquired.

Julie acquires 100 shares under an ESS in Feeney group. Following a restructure, Feeney group is demerged into KMC group and Coopers group; Julie is employed by a subsidiary of KMC group. As a result of the restructure, one share in Feeney group will be exchanged for one share in KMC group and half a share in Coopers group. The 100 shares Julie acquires in KMC group and 50 shares in Coopers group are deemed to be matching shares for the 100 shares in Feeney group. However, the 100 shares in KMC group are treated as a continuation of the same proportion of the shares in the Feeney Group, for which Julie can obtain a roll-over relief, as her employment with KMC group is considered as a continuation of her employment with Feeney group. For the 50 Coopers group shares that Julie holds that match the shares in the Feeney group, an income taxing point for the same proportion of shares in the Feeney group arises. A deferred taxing point will occur because there is no continuation of employment with the Coopers Group.



*Apportionment of cost base of old interests*

1.184 Things that are acquired by the employee in connection with the takeover or restructure and can reasonably be regarded as matching the old interests (including all of the new interests) or in the case of the

restructure, the same interests held before are still held after and can reasonably be considered at matching the existing interests.

1.185 The employee is to be treated as having given as consideration for the assets, the amount worked out by apportioning among those assets, according to their respective market values immediately after the takeover or restructure, the total of

- the cost bases of the old interests they ceased to be held; and
- the cost bases of any assets that were held before the restructure and are still held after the restructure taken immediately after the takeover or restructure.

*[Schedule 1, item 1, subsection 83A-125(6)]*

1.186 This only applies to employees who, at the time they acquire the new interests, do not hold a beneficial interest in more than five per cent of the shares in the new company, and are not in a position to cast more than five per cent of the maximum number of votes that could be cast at a general meeting of the new company. *[Schedule 1, item 1, subparagraphs 83A-125(8)(i) and (ii)]*

## **Protecting the integrity of employee share schemes**

1.187 The employee share scheme tax law is designed to ensure the integrity of the taxation of employee share schemes. The new law reproduces a number of integrity provisions in the current law and introduces a number of new integrity provisions.

### ***Interests provided to associates***

1.188 The new law continues to treat employee share scheme interests provided to associates of employees, in relation to an employee's employment, as though the interest was in fact acquired by the employee rather than the associate. *[Schedule 1, item 1, section 83A-305]*

1.189 This provision is designed to ensure that arrangements are not artificially constructed to avoid the employee share scheme tax rules, or to lessen a tax liability incurred in relation to ESS interests, by providing benefits to associates of an employee.

1.190 The definition of associate aligns with the broad definition used across the tax law (see section 318 of the ITAA 1936).

1.191 The employee share scheme arrangements expressly exclude an employee share trust from being subject to the associate rules *[Schedule 1,*

*item 1, section 83A-305*. This is because a beneficial interest in a trust by an employee will be taxed as though the interest was held by the employee anyway, separate to the provision relating to associates. For further discussion on the treatment of trusts, see paragraphs 1.192 to 1.196.

#### ***Interests in a trust***

1.192 The new law is designed to ensure that employees with a beneficial interest in shares in a trust will be taxed as though they were the legal owners of those shares. This is so that employees cannot lessen, delay or avoid their tax liability by interposing a trust.

1.193 An ESS interest is defined as a *beneficial* interest so that an individual pays tax only on shares or rights that they are receiving the economic benefit of, regardless of whether they are also the legal owner of the shares or rights, or whether those shares or rights are held in a contractual or trust relationship for them. [*Schedule 1, item 1, subsection 83A-10(1)*]

1.194 Further, to overcome trust law restrictions on identifying assets for which an employee holds a beneficial interest when they are held in a trust within a single pool of unidentified assets, the new law enables the Commissioner to treat particular shares or rights to acquire a shares in a trust as though they were beneficially owned by particular employees. [*Schedule 1, item 1, subsections 83A-320(1), (2) and (4)*]

1.195 However, the rules acknowledge the use of employee share trusts as a legitimate mechanism to provide ESS interests to employees that are 'at risk'. This provides that ESS interests which are at real risk of forfeiture can be placed in an employee share trust rather than in the legal ownership of the employee or employer.

1.196 In the case where a trust holds multiple classes of assets, the rules are applied separately to each class of assets. [*Schedule 1, item 1, subsection 83A-320(3)*]

#### ***TFN withholding tax (ESS)***

1.197 The new law introduces a withholding tax, applicable in limited circumstances, to ensure the integrity of the taxation of employee share schemes.

1.198 The *TFN withholding tax (ESS)* is defined in the TAA 1953, and is hereafter referred to as the withholding tax. [*Schedule 1, item 38, subsection 130-80(3)*]

1.199 The withholding tax is payable if an employer provides discounted shares and rights to an employee, and that employee has not

quoted their Tax File Number (TFN), or their Australian Business Number (ABN) to the employer by the end of the income year. *[Schedule 1, item 2, subsections 14-155(1) (3) in Schedule 1 to the TAA 1953, and clause 3 of Income Tax (TFN Withholding Tax (ESS) Bill 2009]*

1.200 An employee refusing to provide their employer with a TFN or ABN (as the case requires) undermines the new law relating to employer reporting requirements, which are important to ensuring the integrity of employee share scheme taxation.

1.201 If the employer does not report a TFN or ABN, the Commissioner will not easily be able to identify the employee to whom the discounted shares or rights have been provided (to ensure the correct tax is paid). Imposing a withholding tax in these cases will ensure that tax is in fact paid.

1.202 It is rare for an employee to refuse to provide their employer with a TFN, so the withholding tax will not be commonly levied.

1.203 The withholding tax is payable on the amount of ESS discount included in an employee's assessable income for an income year under the general employee share scheme tax rules, disregarding any application of the upfront tax concession. *[Clause 3 of Income Tax (TFN Withholding Tax (ESS) Bill 2009]*

1.204 The rate of tax is calculated by adding the highest individual marginal tax rate to the rate of the Medicare levy *[Clause 4 of Income Tax (TFN Withholding Tax (ESS) Bill 2009]*. This rate ensures that high income individuals cannot pay less tax by withholding their TFN or ABN from their employer.

1.205 For the purposes of the withholding tax, any upfront concession that may be available to the employee (reducing the amount of discount that is included in their assessable income) is disregarded. *[Schedule 1, item 2, subsection 14-155 (2) in Schedule 1 to the TAA 1953 and clause 5 of the Income Tax (TFN Withholding Tax (ESS)) Bill 2009]*

1.206 This is because an employer who incurs withholding tax may not know whether or not the relevant employee meets the income test for the upfront concession.

1.207 Withholding tax is payable 21 days after the end of the income year in which the ESS interest is included in the employee's assessable income. This will be the year that the shares or rights were provided in the case of upfront taxation schemes, or the year of the ESS deferred taxing point for deferred tax schemes. *[Schedule 1, item 2, subsection 14-155 (4) in Schedule 1 to the TAA 1953]*

1.208 When withholding tax is levied on an employer, they can recover the amount of withholding tax that they have paid from the employee to whom the amount of tax related. The employer can do this by offsetting the amount they can recover from the employee against an amount they otherwise owed the employee, such as the employee's salary. *[Schedule 1, item 2, section 14-160 in Schedule 1 to the TAA 1953]*

1.209 Allowing the employer to recover the amount of withholding tax as a debt from the employee will mean that the tax is actually borne by the employee. This is appropriate as it is the employee who has the beneficial interest in the shares or rights, and the employee who will receive a tax credit for any withholding tax paid.

1.210 When calculating an employee's tax payable for an income year, the employee is given a credit for any withholding tax that has been paid by their employer in relation to them. *[Schedule 1, item 2, section 14-165 in Schedule 1 to the TAA 1953]*

1.211 The withholding tax will generally result in the same financial outcome for the employer or the employee than they would otherwise have received had the employee provided their TFN or ABN. When withholding is levied:

- the employer will be able to recover a debt equal to any withholding tax paid from the employee; and
- the employee will receive a tax credit for withholding tax paid, which will be applied when the Commissioner makes their tax assessment for the income year.

1.212 If there is an overpayment of withholding tax by the employer, the Commissioner must refund the amount that has been overpaid to the employer, and the relevant employee will not receive a tax credit for that amount (nor will they have to pay any amount to the employer as a debt). *[Schedule 1, item 2, section 14-175 in Schedule 1 to the TAA 1953]*

1.213 The employee share scheme rules relating to takeovers and restructures, discounted shares or rights acquired by associates, relationships similar to employment, and to stapled securities, also apply to the withholding tax. *[Schedule 1, item 2, section 14-180 in Schedule 1 to the TAA 1953]*

1.214 Any withholding tax must be paid by a method provided for under the general machinery rules of the TAA 1953, and any amount of withholding tax that is not paid by the due date will result in the employer being liable for the general interest charge on the unpaid amount. *[Schedule 1, items 3 and 4, subsection 16-70(3) and section 16-80]*

### **Example 1.14 Operation of the TFN Withholding tax ESS**

Georgina is an employee of Ginger Bank in the 2009-10 income year. Ginger Bank operates an employee share scheme, and has provided Georgina with shares in Ginger Bank under an employee share scheme at a \$100 discount to their market value. Ginger Bank's employee share scheme is an upfront taxation scheme. However, Georgina has not quoted her TFN to Ginger Bank by the end of the income year.

As a result, Ginger Bank is liable for withholding tax. Ginger Bank must pay this to the Commissioner no later than 21 days after the end of the income year.

The rate of the withholding tax will be 46.5 per cent in the 2009-10 income year.

Multiplying the discount Georgina received by the rate of the withholding tax will give Ginger Bank's withholding tax liability:  $46.5\% \times \$100 = \$46.50$ . So, Ginger Bank must pay \$46.50 to the Commissioner.

Ginger Bank may then recover \$46.50 from Georgina as a debt. In this case, Ginger Bank and Georgina agree that \$46.50 will be deducted from her salary.

When the Commissioner makes Georgina's income tax assessment for the 2009-10 income year, she will receive a tax credit of \$46.50 in recognition of the withholding tax paid by Ginger Bank. Of course, the \$100 discount she received through Ginger Bank's employee share scheme will be included in her assessable income.

In the end, Ginger Bank is no worse off, as they paid \$46.50 to the ATO, and received \$46.50 from Georgina. Once the ATO calculates Georgina's amount of tax payable for 2009-10, her tax outcome is no different than it would have been had she provided her TFN or ABN to Ginger Bank in the first place. She will receive a credit from the ATO of \$46.50, but include the \$100 discount in her assessable income (unless the upfront concession is applicable).

#### ***Employer reporting***

1.215 The new law requires employers who provide ESS interests to report certain information to the Commissioner, to enable him to ensure that the employee share scheme tax law is being complied with.

1.216 An employer who provides ESS interests to an employee during a year must, at the end of the year, and in certain cases at the end of a later year, report to the Commissioner and to the employee.

1.217 These reporting requirements boost the integrity of the taxation of share schemes, addressing concerns that the current employee share scheme rules are not being complied with and that the Commissioner is not in a position to know the full extent of that non compliance. The reporting requirements will provide the Commissioner with the information to conduct data matching activities and ensure that employees comply with the rules.

1.218 An employer must provide a statement to the Commissioner and to the employee if:

- the employer provided interests to the employee during the year which were taxed under the employee share scheme tax rules; or
- the employer has provided deferred tax interests to the employee (during the year or previous), and the ESS deferred taxing point for the interests occurred during the year.

*[Schedule 1, item 5, subsection 392-5(1) in Schedule 1 to the TAA 1953]*

1.219 An administrative penalty applies to employers who fail to provide this statement.

1.220 The statement must be provided in a form approved by the Commissioner, containing any required information or signed declarations, and provided to the Commissioner in the required manner. *[Schedule 1, item 5, section 392-5(2) in Schedule 1 to the Taxation Administration Act 1953]*

1.221 The legislation outlines some of the particular information that the Commissioner may require in the approved form. This is provided to better illustrate the intent of the employer reporting requirements, and to provide some guidance to employers and employees as to the sort of information the Commissioner might require.

1.222 It does not limit the information the Commissioner could require and does not even mean the Commissioner has to require the listed information. *[item 5, subsection 392-5 (5) in Schedule 1 of the TAA 1953]*

1.223 The approved form may require the statement to contain:

- the employer's ABN;
- the employee's name and address;
- the employee's TFN (if it has been provided to the employer);

- the employee's ABN (if it has been provided to the employer);
- the following information about any ESS interests which have been provided during the income year and will be taxed upfront:
  - the number of the interests;
  - the amount paid, at or before the time of acquisition, towards acquiring the interests;
  - the employer's estimate of the market value of the interests at the time of acquisition;
  - the amount of withholding tax (if any) paid in respect of the interests during the year;
- the following information about any interests which have been provided during the income year and on which tax will be deferred:
  - the number of the interests;
  - the amount paid, at or before the time of acquisition, towards acquiring the interests;
- the following information about any interests that the employer has provided to an employee during the year or during a previous year, on which tax was deferred, and the ESS deferred taxing point for those interests occurred during the year.
  - the number of the interests;
  - the amount paid, after the time of acquisition but not after the ESS deferred taxing point, towards acquiring the interests;
  - the provider's estimate of the market value of the interests at the ESS deferred taxing point;
  - the amount of withholding tax if any the provider paid in respect of the interests during the year.

*[Schedule 1, item 5, subsection 392-5(3) in Schedule 1 of the TAA 1953]*

1.224 The legislative guidance that is provided on what the Commissioner may require in the approved form does not in any way limit the information that the Commissioner may or may not require. The required statements must be given by the employer to the employee no later than 14 July after the end of the year; and to the Commissioner no later than 14 August after the end of the year [*Schedule 1, item 5, subsection 392-5 (3) in Schedule 1 of the TAA 1953*]. If the employer is unable to meet the deadline the Commissioner may defer the deadlines under the general machinery provisions.

1.225 If, after providing the statement, the employer becomes aware of any information that has materially changed or been omitted in the statement, within 30 days of becoming aware of the change or omission they must either inform the employee and the Commissioner; or provide the omitted information to the employee and the Commissioner. [*Schedule 1, item 5, section 392-10 in Schedule 1 of the TAA 1953*]

1.226 The employee share scheme rules relating to takeovers and restructures, discounted shares or rights acquired by associates, relationships similar to employment, and to stapled securities, also apply for the purposes of employer reporting requirements. [*Schedule 1, item 5, section 392-15 in Schedule 1 of the TAA 1953*]

#### ***Interests may relate to past or prospective employers***

1.227 An employee share scheme is defined as a scheme for providing ESS interests in a company to employees, (including past or prospective employees) of the employer. [*Schedule 1, item 1, subsection 83A-10(2)*]

1.228 The extension to past or prospective employees is an integrity measure to ensure that arrangements are not deliberately designed to occur before or after employment in order to avoid the employee share scheme rules. This is consistent with the general treatment of employment income elsewhere in the tax law.

#### **Refund of tax for forfeited shares**

1.229 The new law provides for a refund of tax paid in relation to discounted ESS interests in certain circumstances where those interests are forfeited after the employee has been taxed on the discount.

1.230 The refund is only available where the employee had no choice but to forfeit the ESS interest, and where the conditions of the scheme were not constructed to protect the employee from market risk.

1.231 Under such circumstances, the forfeited ESS interest is treated as never having been acquired, and the taxpayer can claim a refund of

income tax by amending their assessment to remove income previously included in their assessable income. There is no time limit on amending an assessment to exclude an amount from a taxpayer's assessable income for a share interest which is forfeited, or for a right which was lost without being exercised.

1.232 As the refund provisions are not intended to protect the employee from downside market risk, a refund will not be available where the share interest is forfeited only because the value of the securities has fallen due to market losses.

1.233 Specifically, the new law is taken never to have applied in relation to an ESS interest where:

- an amount of employee share scheme discount has been or would be included in the employee's assessable income;
- the employee has either forfeited the ESS interest or, in the case of a right, the employee has lost the right without having disposed of or exercised it; and
- the forfeiture or loss is not the result of a choice made by the individual, and nor is it the result of a condition of the scheme that has the direct effect of wholly or partly protecting the employee from a fall in the market value of the ESS interest.

*[Schedule 1, item 1, subsection 83A-310]*

1.234 In situations where the ESS rules do apply to the ESS interest, the taxpayer may be able to claim a capital loss under the CGT provisions.

**Example 1.15: Employment condition not met**

Megan enters into an ESS arrangement with her employer, BAS. She will receive 1,000 BAS shares if the company's market share has increased in the next two years.

Megan ceases employment after one year and pays tax on the discount she received for the 1,000 BAS shares. At the end of the two year period, the market share of BAS did not increase and her shares are forfeited.

*Eligible for refund:* Yes. The share interest was forfeited because a genuine performance hurdle was not met.

**Example 1.16: Share interest forfeited due to market loss**

Jane enters into an ESS arrangement with her employer, SYS. She will receive rights to 1,000 SYS shares if she is still employed with SYS in one year.

After one year, Jane has met this performance hurdle and pays tax on the discount she received on the rights to 1,000 SYS shares. She has a two year window to exercise the rights to the shares. As the market price of SYS shares declines by the end of the two year window, Jane decides to forfeit her share interests.

*Eligible for refund:* No. The share interest was forfeited because a choice made by Jane. Jane will be able to claim for a capital loss for the cost base of the rights.

**Example 1.17: Contrived scheme linked to market performance**

Tom enters into an ESS arrangement that is not subject to deferral or the upfront concession with his employer, SYD. He will receive rights to 1,000 SYD shares in five years if the market price is above the strike rate agreed upon.

Tom pays tax upfront on the discount he received on the rights to the 1,000 SYD shares. After five years, the market price is below the agreed strike rate and the rights are forfeited.

*Eligible for refund:* No. Even though Tom did not choose to forfeit the rights, the ESS arrangement is contrived to ensure participating taxpayers are not exposed to downside market risk.

**Example 1.18: Eligible performance hurdle linked to market price**

Tony enters into an ESS arrangement that is not subject to deferral or the upfront concession with his employer, WWW. He will receive 1,000 WWW shares in one year, if WWW's market price increases by 20 per cent in 12 months time.

Tony pays tax upfront on the discount he received on the 1,000 WWW shares. The market price of WWW shares decline in the 12 month period, and he forfeits his share interest.

*Eligible for refund:* Yes. The share interest was forfeited because a genuine performance hurdle was not met and as such, Tony did not have a choice about whether or not the share interests were forfeited.

**Deduction by employers**

1.235 Under the general income tax law, an employer could not deduct anything for directly providing shares or rights to shares in itself to its

employees. This is because the issue of share capital would not be a loss or outgoing even though it relates to the remuneration of its employees.

*Specific deduction*

1.236 In order to encourage the provision of shares, stapled securities and rights to shares or stapled securities under certain employee share schemes, a limited specific deduction is provided to employers. An employer can deduct an amount for shares, stapled securities and rights to shares or stapled securities they provide to employees under an employee share scheme if the employee is eligible for a reduction in the amount of the discount they would otherwise have to include in their assessable income in relation to that security. *[Schedule 1, item 1, subsection 83A-200(1)]*

1.237 The amount of the deduction is equal to the discount received by the employee on the security that they did not have to include in their assessable income because the security came from a scheme that meets the conditions for the upfront concession detailed in paragraphs 1.88 to 1.100. The income test for the upfront concession is disregarded when determining an employer's eligibility to claim a deduction. *[Schedule 1, item 1, subsection 83A-200(2)]*

1.238 The maximum deduction is \$1,000 which is equal to the maximum amount that an employee is entitled to reduce the discount included in their assessable income by.

1.239 If 2 or more employers jointly provide the security to an employee, the deduction is to be apportioned between them on a reasonable basis. *[Schedule 1, item 1, subsection 83A-200(4)]*

**Example 1.19**

Alister receives 1,000 stapled securities from his employer, Taxation Services Pty Ltd, under an employee share scheme. Alister's adjusted taxable income is less than \$180,000. The stapled securities are valued at \$1 each and Alister has not had to pay anything towards acquiring them under the employee share scheme.

The employee share scheme has been provided on a non-discriminatory basis, Alister has no real risk of losing the stapled security, he has no other securities in his employer, he is required to hold the securities for at least 3 years, the stapled security contains an ordinary share in Taxation Services Pty Ltd and a unit in a unit trust, Taxation Services Service Trust.

Alister would be entitled to reduce the \$1,000 discount included in his assessable income from the acquisition of the stapled securities by \$1,000.

The stapled securities were jointly provided by Taxation Services Pty Ltd and Taxation Services Service Trust (treated under the employee share scheme rules as one entity).

Taxation Services Pty Ltd and Taxation Services Service Trust would need to apportion the deduction between them. As the value each component part of stapled security is equal, a reasonable apportionment would be for each to receive \$500 deduction.

#### *Timing of general deduction*

1.240 A general deduction may be available in relation to the indirect provision of securities to employees under an employee share scheme. An employer may provide money to an employee share trust for the purpose of providing its employees with securities in itself. The employee share trust may acquire the securities by buying them on a market or by participating in a share issue by the employer.

1.241 An employer could generally deduct an amount of money or property (not being securities in itself) provided to a employee share trust for the purpose of remunerating its employees under an employee share scheme.

1.242 The deduction would generally occur in the income year in which the employer incurred the loss or outgoing. However, this arrangement may allow an employer to artificially bring forward future deductions by making contributions to the trust that are in excess of its requirements under an employee share scheme.

1.243 To prevent an artificial bring forward of these deductions, the employee share scheme rules delay the deduction until the employee acquires an ESS interest. [*Schedule 1, item 1, section 83A-205*]

1.244 The situations in which a deduction is deferred is not limited to cases involving an employee share trust. Any arrangement in which an employer provides ESS interests under an employee share scheme indirectly by providing another entity with money or property will result in a deduction being deferred until the employee acquires the security.

#### *Amending tax returns relating to employee share schemes*

1.245 There is no limit to when the Commissioner of Taxation can amend an assessment relating to an employee share scheme.

Since the tax on an ESS share interest can be deferred for up to 7 years, and it will not be known before hand whether or not shares will be forfeited, it does not make sense to limit the period to which a tax return can be amended.

## Foreign employment

1.246 Consistent with the treatment of most other types of income, whether an amount is included in a taxpayer's assessable income under the new ESS rules will depend on the taxpayer's residency status and the source of the income.

1.247 Under the core rules of the Australian income tax system, an Australian resident taxpayer is subject to income tax on their worldwide income. A foreign resident taxpayer is only subject to Australian income tax on their Australian sourced income.

1.248 Under the existing law, this outcome is achieved by excluding discounts from the existing ESS rules on interests acquired under employee share schemes to the extent that it relates to the foreign service of the taxpayer.

1.249 This mechanism operates in a manner inconsistent with core rules. The new ESS rules use the core rules to achieve the desired outcome. The new ESS rules instead include source rules and rely on the core rules to the exclude foreign sourced income of foreign residents from Australian income tax. That is, the ESS rules attribute a source to discounts received on securities acquired under employee share schemes.

1.250 To the extent that a discount on a security relates to employment outside Australia, the discount is taken to be from a foreign source. In the case of a security that is subject to a deferred taxing point, it is the amount included in your assessable income that is attributed a source (i.e., both the discount and subsequent gains are attributed with a source). The attribution is done in manner consistent with the rule applying to discounts. [*Schedule 1, item 1, subsections 83A-15(2) and 83A-105(2)*]

1.251 Whether the discount on the security acquired under an employee share scheme relates to employment in Australia or outside Australia is a question of fact that needs to be determined on a case-by-case basis.

1.252 Australian resident taxpayers are subject to Australian income tax on all discounts they receive on securities acquired under employee share schemes regardless of whether they received it in relation to employment in Australia or outside Australia. However, this may be affected by Australia's double tax treaties.

1.253 Foreign resident taxpayers are only subject to Australian income tax on discounts they receive on securities acquired under employee share schemes to the extent that the discount relates to the employment in

Australia. The core rules are contained in sections 6-5 and 6-10 of the ITAA 1997.

1.254 The outcome effectively mirrors the tax treatment of employment income.

**Example 1.20**

Bob is a foreign resident and works for a multinational company, Janelle Limited (Janelle) in Hong Kong.

Bob receives 1,000 shares in Janelle under Janelle's employee share scheme for no consideration. The 1,000 shares relate to Bob's employment with Janelle over the next 24 months and have a market value of \$5,000. The shares are subject to forfeiture conditions.

12 months after acquiring the shares under the employee share scheme, Janelle transfers Bob to Australia for 5 months to work in Janelle's Australian operations in Darwin. After the 5 month posting, Bob returns to Hong Kong.

At the end of the 24 months, the forfeiture conditions cease to apply and Bob and no disposal restrictions exist. The shares at this time are subject to an ESS deferred taxing point. The market value of the shares is \$10,000 at the taxing point.

Bob notionally includes in his assessable income the full \$10,000. The ESS rules attribute \$2083 (5/24) to be from an Australian source and \$7917 (19/24) to be from a foreign source.

As Bob is a foreign resident, only the \$2083 is included in his taxable income.

**Temporary residents**

1.255 The rules applying to temporary residents have been amended as a result of these reforms.

1.256 The temporary residents' provisions provide exemptions from Australian tax on foreign sourced income of individuals who are considered to be temporary residents of Australia for tax purposes.

1.257 These exemptions extend to capital gains tax (CGT) exemptions for capital gains realised on CGT assets that are not taxable Australian property. However, part of the capital gains realised on some shares and rights acquired under employee share schemes were excluded from these general exemptions. This was done to discourage the possible re-characterisation of employment income as a capital gain to avoid tax.

1.258 With the introduction of the new integrity rules applying to employee share schemes, the potential for taxpayers to exploit the temporary residents' rules has been minimised.

1.259 The current employee share scheme exceptions to the temporary residents are highly complex. They seek to only provide the exemption to the part of a capital gain realised on ESS interests that were subject to upfront taxation and accrued before a notional deferred taxing point. Replicating these rules within the new taxation framework would add significant complexity and compliance costs.

1.260 Given the new framework underlying the taxation of employee share schemes, it is no longer necessary to maintain these exceptions to the general temporary residents' exemptions. These amendments therefore repeal those exceptions. [*Schedule 1, item 61*]

1.261 Capital gains realised on shares and rights acquired under an employee share scheme (after a taxing point has occurred under Division 83A) will be eligible for the temporary residents' CGT exemption similar to other CGT assets, regardless of whether a notional taxing point has occurred or not.

1.262 Consistent with other CGT assets, the temporary residents' exemptions will not apply to shares or rights acquired under an employee share scheme if those shares or rights are taxable Australian property.

1.263 There are also a number of other minor amendments made to the temporary residents rules to update referencing, to turn off its application until the employee share scheme rules have stopped applying to an ESS interest and to ensure that the cost setting rules within the employee share scheme rules interact correctly with those in the temporary residents' rules. [*Schedule 1, items 60 and 62 to 63*]

## Miscellaneous

### *Relationships similar to employment*

1.264 The employee share scheme rules cover not only employees of a company offering an employee share scheme, but also cover employees in relationships similar to employment.

1.265 This is to ensure that people such as directors or office holders who are not considered employees, but who are in an employee-like relationship are not excluded from participating in employee share schemes.

1.266 The rules also cover taxpayers who are independent contractors.

### ***Ceasing employment provision***

1.267 An employee is considered to have ceased employment when they are no longer employed either by their employer, a holding company or subsidiary of their employer, or a subsidiary of a holding company. *[Schedule 1, item 1, section 83A-330]*

### ***Stapled securities***

1.268 Stapled securities are treated in the same way as shares under the ESS rules provided at least one of the elements of the stapled security is a share in a company. This limitation is necessary in order to maintain the necessary link of the rules with acquisitions of interests in corporate entities. *[Schedule 1, item 1, subsection 83A-335(1)]*

1.269 In other words, these stapled securities acquired under an employee share scheme are subject to the ESS rules as if the stapled security were a share in a company. Rights to stapled securities are treated in the same way as rights to shares.

1.270 Employees who receive a stapled security under an employee share scheme must therefore include in their assessable income any discount received on acquisition of that security.

1.271 A condition for eligibility for any of the employee share scheme tax concessions is that the security acquired under the scheme relates to an ordinary share. In the case of a stapled security, it meets this condition if the stapled security is made up of share that is an ordinary share. *[Schedule 1, item 1, subsection 83A-335(2)]*

1.272 The stapled security includes interests in two or more entities. For the purposes of the ESS rules, these entities are taken to be one single entity. More specifically, the non-corporate entities are taken to be parts of the corporate entity. This allows, amongst other things, for the employment conditions to be satisfied. *[Schedule 1, item 1, subsection 83A-335(3)]*

1.273 As a result of consultation, the new ESS rules have been applied more broadly than the previous ESS rules. The ESS rules apply to a wider class of stapled securities.

### **Example 1.21**

Kim is employed by Kiwi Dairy Property Trust in Bega. Units in Kiwi Dairy Property Trust are stapled with shares in Kiwi Dairy Limited. Kim acquires 2,000 stapled securities under an employee share scheme. The securities have a market value of \$1.50 per security and Kim has paid 50¢ towards each security.

As each stapled security contains at least one share in a company, the stapled security is covered by the ESS rules in the same way as the ESS rules apply to shares.

Therefore, the discount Kim receives on the acquisition of the securities must be included in her assessable income (\$2,000).

However, the employee share scheme and Kim's acquisition of the security meet the conditions for deferral of the taxing point including because Kim's employment is taken to be with a company (as ESS rules treat the trust as part of the company) and the share in Kiwi Dairy Limited is an ordinary share.

Kim must defer including the discount in her assessable income until the deferred taxing point occurs.

### ***Entities treated like companies***

1.274 In certain cases and for various reasons, the tax law treats particular classes of particular entities as companies. Most often, this is for reasons of integrity.

1.275 Examples of this are corporate limited partnerships and corporate unit trusts and public trading trusts under the consolidation rules. Under the corporate limited partnership rules and the consolidation regime rules dealing with corporate unit trusts and public trading trusts, those entities are treated as companies for all tax law purposes. This includes treating interests in those entities as shares in a company.

1.276 The ESS rules therefore also apply to interests in these entities acquired under employee share schemes in the same way as the rules apply to shares in companies.

### **Example 1.22**

Litsa is employed by AF & TS remuneration specialists which is a corporate limited partnership.

Litsa receives an interest in the corporate limited partnership under an employee share scheme (i.e., she buys into the partnership). The interest is provided to Litsa at a 10% discount to the market value.

The discount is included in Litsa's assessable income in the year she acquired the interest. The interest is not subject to forfeiture conditions and Litsa is not required to hold the interest for a minimum period.

### ***Interaction with fringe benefits tax***

1.277 The new rules carve employee share schemes out of fringe benefits taxation, to prevent double taxation.

1.278 Fringe benefits law would normally also assess a discount received by an employee via an employee share scheme (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 to avoid double taxing the benefit.

1.279 Since the new measures provide a specific regime which brings the discount to account as assessable income, taxing the discount as a fringe benefit would otherwise result in double taxation.

### ***Ability to amend tax return***

1.280 There is no limit to when the Commissioner can amend an assessment relating to an employee share scheme.

1.281 Since the tax on an ESS interest can be deferred for up to 7 years, and it will not be known before hand whether or not shares will be forfeited, it is inappropriate to limit the period to which a tax return can be amended. This is particularly the case where benefits are subject to a real risk of forfeiture.

## **Application and transitional provisions**

1.282 The new rules apply to shares, rights and stapled securities acquired on and after 1 July 2009.

1.283 In order to simplify the law and improve the interaction of the employee share scheme rules with other areas of the law, shares, rights and stapled securities acquired before this time will also be brought within the new rules. However, transitional arrangements will be provided to ensure the effect of the existing law is maintained for securities acquired before 1 July 2009.

## Consequential amendments

### *Amendments relating to capital gains tax (CGT)*

- 1.284 The new law continues to exempt ESS interests from taxation under the CGT provisions until the employee share scheme tax rules no longer apply to them. *[Schedule 1, item 40, Subdivision 130-D]*
- 1.285 This is because particular concessional tax treatment is deliberately applied to employee share schemes, and the CGT provisions are not intended to apply. *[Schedule 1, item 40, section 130-75]*
- 1.286 Any CGT event that occurs in relation to an ESS interest prior to it being taxed under the employee share scheme rules will be disregarded, with the exception of certain events that may have an impact on the cost base of the interest. *[Schedule 1, item 40, subsection 130-80 (1)]*
- 1.287 An *employee share trust* is a trust which only holds employee share scheme interests, and provides them to employee or their associates. *[Schedule 1, item 40, subsection 130-80 (3)]*
- 1.288 The CGT events that occur when a beneficiary of a trust becomes absolutely entitled to an interest will be disregarded if that interest is in an employee share trust *[Schedule 1, item 40, subsection 130-80 (2)]*. These rules are not needed as the employee share scheme rules already tax an interest in a trust as though it were the employee's.
- 1.289 This exception is restricted to employee share trusts (as opposed to other trusts) for reasons of integrity.
- 1.290 The new law ensures that if an ESS interest is forfeited, the CGT integrity provision which substitutes market value when the disposal or cancellation of an asset results in no capital proceeds will not apply *[Schedule 1, item 43, sections 208-215]*. This provision would not be appropriate because there are legitimate circumstances in which an ESS interest may be forfeited, resulting in no capital proceeds.

### **Example 1.23 Interaction between the employee share scheme rules and CGT**

Annette acquires ESS interests which have a market value of \$300 under an employee share scheme for \$200, that is, at a \$100 discount to their market value.

The scheme Annette participates in meets the conditions for deferral of tax, so she must defer until the ESS deferred taxing point occurs. For as long as tax is deferred, any CGT events are disregarded (with the exception of certain events that may have an impact on the cost base).

Four years after she acquired the ESS interests Annette ceases employment with her employer, triggering the deferred taxing point. The ESS interests now have a market value of \$400. The employee share scheme tax rules require her to include the value of the discount and subsequent market gains (current market value less the cost base is \$200) in her assessable income. It will be taxed at Annette's marginal tax rate.

At this point the asset (the ESS interest) is taken to have been reacquired for, amongst other things, CGT purposes. The asset will now have a cost base of \$400.

Because the asset is taken to be reacquired, if Annette chose to dispose of the asset within 12 months of the ESS deferred taxing point occurring, she would not be able to apply the CGT discount.

However, in this example she chooses to sell the asset (originally acquired under the employee share scheme) two years after the ESS deferred taxing point has occurred for \$600. Annette will pay tax on the \$600 less the cost base of \$400. She will be able to apply the 50 per cent CGT discount, therefore including \$100 in her assessable income (assuming she has no capital losses to apply).

#### **Example 1.24 Interaction between the employee share scheme rules and CGT**

Tom acquires ESS interests which have a market value of \$400 under an employee share scheme for \$100, that is, at a \$300 discount to their market value. The ESS interests are rights to acquire shares in Tom's employer.

The scheme Tom participates in meets the conditions for deferral of tax, so he must defer until the ESS deferred taxing point occurs. For as long as tax is deferred, any CGT events are disregarded (with the exception of certain events that may have an impact on the cost base).

Six months after he acquires the rights, they are no longer under any real risk of forfeiture, and Tom is under no genuine restrictions preventing him from exercising the rights. The market value at that time is \$500. This triggers the ESS deferred taxing point. The employee share scheme tax rules require Tom to include the value of the discount and subsequent market gains (current market value less the cost base is \$400) in his assessable income. It will be taxed at Tom's marginal tax rate.

At this point the asset (the ESS interest) is taken to have been reacquired for, amongst other things, CGT purposes. The asset will now have a cost base of \$500 (the market value when the ESS deferred taxing point occurred).

Because the asset is taken to be reacquired, if Tom chose to dispose of or exercise the rights within 12 months of the ESS deferred taxing point occurring, he would not be able to apply the CGT discount.

Nine months after the ESS deferred taxing point occurred, Tom exercises the rights, and acquires shares. This triggers a CGT event. However, a roll-over applies and any capital gain or loss is disregarded. Because Tom has 'acquired' the shares at the time the rights are exercised, he will not be able to apply the CGT discount in relation to them for a further 12 months. The cost base of the shares will be taken to be the cost base of the previous rights (see the rollover provisions in Division 134 of the ITAA 1997). That is, the shares will have a cost base of \$500.

Nine months after Tom exercised the rights and acquired shares, he sells the shares at their market value of \$700. Tom will pay tax on the \$700 less the cost base of \$500. Because it is less than 12 months since the previous CGT event (when he exercised the rights) Tom is may not apply the CGT discount.

#### ***Other amendments***

1.291 There are also amendments tidying up assorted references, headings, notes and other things that need to be removed or changed because the employee share scheme rules have been rewritten into the ITAA 1997, and the terminology used to refer to concepts in the taxing of employee share schemes is different. [*Schedule 1, items 12 to 14, 16,, 17, 21, 22, 24 to 33, 35, 36, 38, 39, 43 to 50, 52 to 58*]



