1. The Role and Relevance of Tax to Share Based Rewards

Tax in the context of employee share plans plays two different roles. The first is to ensure that a taxing time does not arise for share based rewards before those rewards are 'derived' (refer 1.1). This role does not encourage employee share ownership but merely ensures that tax is not a detriment to offering employee share rewards compared to offering other rewards. The second of these roles is to potentially provide tax concessions in appropriate circumstances to encourage employee share ownership (refer 1.2).

1.1 Ensuring that a taxing time does not arise before rewards are derived

It is a basic principle of fair and sensible tax laws that individuals should not be taxed on employment related benefits until those benefits are derived. Employment related benefits would not generally be derived until the employee was able to 'access' those benefits. For example, employees are generally taxed on cash bonuses when received, rather than at the beginning of the year when they are told that they will potentially be entitled to a cash bonus of up to x% of their base salary conditional on both their and their employer's performance during that year.

Applying the derivation principle to share based awards would indicate that an employee should not be taxed on such awards until there is reasonable certainty that the employee is not going to loose the award and the employee is not prohibited from selling the award. This is consistent with the structure of Division 13A which currently allows a tax deferral for qualifying shares which are subject to either restrictions preventing the disposal of the shares or forfeiture conditions and allowing a tax deferral for rights until those rights are exercised.

Ensuring that the taxing time is not before derivation does not 'encourage' employee share ownership and should not be seen as a concession. It merely ensures that tax is not a detriment to offering employee share rewards compared to offering other rewards. If tax were to be imposed on share based rewards prior to the derivation point, it would seem logical to expect that would create a bias against the offering of employee share plans in Australia.

1.2 Providing in appropriate circumstances a tax concession to encourage employee share ownership

Tax 'concessions' are a matter for Government policy. For example, if the Government wanted to encourage employee share ownership amongst a wider range of Australians, that could potentially be achieved through targeted tax concessions for employee share ownership. It is relevant to note in this respect that both the US and the UK, and various other countries, offer specifically targeted tax concessions for employee share ownership.

The $1,000 tax exemption that has been available under Division 13A is such a concession (albeit a limited one). However it is wrong to think of 'tax deferral' under Division 13A as a tax 'concession' except in some limited circumstances. Rather, in a lot of cases, 'tax deferral' under Division 13A is nothing more than an appropriate recognition of the derivation principle as discussed at 1.1 above. It is also relevant to note that tax deferral

under Division 13A comes at the cost of the loss of the 50% capital gains tax concession on any capital growth during the tax deferral period.

2. Is the Taxing Time under Division 13A Excessively Concessional?

One of the main concerns and key objectives that the Government has identified in making the proposed amendments to the taxation of employee share schemes is to address the issue of 'excessive concessionality' that it perceives is available under Division 13A of the Income Tax Assessment Act 1936.

It is therefore relevant to examine whether there is 'excessive concessionality' under Division 13A in the context of the taxing time which applies under Division 13A. It is relevant to note in this context that Division 13A has been operative since 1995 (ie for almost 15 years) and has not been the subject of any recent amendments or cases which would indicate that the provisions are operating in a way other than as originally intended when those provisions were drafted.

2.1 What is the current taxing time under Division 13A?

The taxing time under Division 13A for qualifying awards is generally as follows:

(a) ***for qualifying shares***: generally when the forfeiture and/or disposal restrictions no longer apply to the shares[1]; and

(b) ***for qualifying rights***: generally when the employee receives the shares the subject of the rights[2].

2.2 Is the Division 13A taxing time excessively concessional?

As discussed at 1.1, the taxing time under Division 13A generally reflects the time at which an employee may be taken to have 'derived' a benefit under general principles. That is, the taxing time generally reflects the time when there is reasonable certainty that the employee is not going to loose the award and the employee is not prohibited from selling the award.

However it is possible in some limited circumstances that the current taxing time under Division 13A may be later than when some or all of the benefit may be considered to be derived under general principles. In that context only, the current taxing time under Division 13A might be viewed as potentially 'concessional' by reference to the derivation principle. However if the Government no longer considered it appropriate to allow for this very limited concessionality in Division 13A, that could simply be achieved by some minor modifications to Division 13A rather than the more substantial amendments that have been proposed.

[1] but may be earlier in some circumstances such as cessation of employment

[2] but may be earlier in some circumstances (e.g. on cessation of employment) and later in some circumstances (e.g. where the shares acquired from the rights are subject to disposal and/or forfeiture conditions).

3. When Should the Taxing Time Arise?

The Government has proposed in the Policy Statement that, where the 'real risk of forfeiture test' is satisfied on grant, the deferred taxing point under the new rules will occur at the earliest of various times. It is submitted that some changes to the proposed taxing times should be made, as outlined below.

3.1 Shares compared to rights to shares

The proposal for the taxing time outlined in the Policy Statement appears to have a more concessional taxing time for shares than for rights. That is, for rights, if the employee is able to exercise from vesting but is prohibited from selling the resulting shares, then the deferral would not appear to continue unless there is a real risk of forfeiture on the shares. This is in contrast to the taxing time for shares and that difference does not appear to have a logical reason.

It is submitted that, consistent with the proposed taxing time for shares, the taxing time for rights which have a real risk of forfeiture on grant should be on the lifting of disposal restrictions on the shares acquired on exercise of the rights without the need for the shares acquired on exercise of the rights to be subject to a real risk of forfeiture (given that risk test would have already been satisfied on grant of the rights).

3.2 Cessation of employment

How could it be considered appropriate to tax an employee on leaving employment on share awards where there is a real risk that the employee may never get to keep those awards? This approach is not taken with cash bonuses and it does not seem logical for it apply to share awards.

For example, assume X Co generally pays its cash bonuses in August of each year based on the performance of the company for the preceding year ended 30 June. Also assume that it is a condition of the bonus terms that you be employed when the bonus is paid except if you have left as a result of redundancy or retirement before that date (in which case if bonuses are paid, you will be paid a time based pro-rata amount). Assume Joe Bloggs retires from X Co in March and receives a pro-rated cash bonus from X Co in the following August. It is clear under current law (and on any sensible application of the derivation principle) that Joe Bloggs should not be taxed on that bonus until he receives it in August, being 5 months after he has left the relevant employment.

For tax to apply on unvested share awards on leaving employment means that the employee has to pay tax on the market value of the shares on leaving the employment even though those shares could be worth considerably less when the awards vest.

Taxing unvested share awards on cessation of employment offends the derivation principle, is not equitable, is out of step with most other countries and appears to have no logical justification.

3.3 Market priced options

Where options have a significant exercise price, there is generally no certainty of benefits until the options are in fact exercised. This is why most other countries tax such options no earlier than on exercise.

Taxing such options on vesting rather than exercise will put Australia out of step with most other countries and is likely to cause significant practical issues for cross border employees who will be taxed on those options at a different time in other countries. It will also require valuation of the options at vesting which will add unnecessary administrative burden for employers.

4. Proposed $5,000 Salary Sacrifice Plans

The Policy Statement indicates that, in addition to satisfying the existing deferral conditions in Division 13A, the scheme will only access this concession if it is a salary sacrifice based employee share scheme offering no more than $5,000 worth of shares to an employee where there is no real risk of forfeiture and the scheme's governing rules clearly distinguish the scheme from those eligible for the upfront exemption.

There is currently very little detail in relation to this proposal so there are numerous things which are unclear about how the arrangements will work in practice, such as the following:

(a) Will real lock up be required for tax deferral or will forfeiture for fraud be sufficient?

(b) Will the amount which is taxed at the later taxing time be limited to the $5,000 or include any capital growth on that amount?

(c) Will the scheme be able to be operate in conjunction with a 'real risk of forfeiture' plan. For example, could an employee be offered to sacrifice $5,000 of salary in return for $5,000 of vested shares which are not subject to forfeiture and $5,000 of 'matching' shares which the employee will only get to keep if the employee remains employed for 3 years?

(d) Will the tax deferral be limited to 'salary sacrifice' plans or also cover plans where the employee is offered the shares or nothing?

It is submitted that further consideration needs to be given to ensure that this proposal is appropriately targeted.

Allens Arthur Robinson
17 July 2009