Taxing Employee Share Schemes (ESS)

ATTA 2016 Conference – University of New South Wales

Prof Stephen Graw

James Cook University

Introduction

It is generally accepted that employee share schemes (ESS) confer a number of benefits not only on participating employees but also on their employers. Those benefits come from aligning employer and employee interests, encouraging positive working relationships, boosting productivity through greater employee involvement in the success or otherwise of the business, reducing staff turnover and encouraging good corporate governance. As an additional benefit employee share schemes can also help cash-strapped start-up, R&D and speculative companies to offer key employees equity in lieu of the higher salaries that the companies' cash position might not permit.

Given the very obvious benefits that such schemes offer, it is unfortunate, but perhaps not surprising, that the taxation treatment to which they have been subject has not been consistent.

The rules were relatively stable from 1995 to 2009 when Division 13A of Part III ITAA36 (and, before it, ITAA 1936 s 26AAC) included the discount to market value at which employees acquired their shares (or rights to acquire shares) in their assessable income – subject, in the case of Div 13A, to two concessions, a 'deferral concession' which allowed employees to defer inclusion of the discount in their taxable income for up to 10 years and an 'exemption concession', which allowed them to exempt the first $1,000 of the discount each year provided certain conditions were satisfied. The two were mutually exclusive and the second could only apply if the employee elected it.

However, unless one of those concessions applied the default position though was that the value of the discount was included in the employee's assessable income when they received the share or right[1] (ie up front). This also had certain advantages in that the value of the discount could then be relatively small - so the tax payable could also be relatively insignificant and might be eclipsed by the benefit that the employee gained when he or she subsequently sold the shares and was taxed on the proceeds not as income but as a capital gain under the more advantageous CGT rules.

[1] *Income Tax Assessment Act 1936* s 139B

Because of concerns that these provisions were being abused, especially in relation to executive remuneration, the then Treasurer announced in the 2009 budget that the taxation treatment of Employee Share Schemes would be amended with effect 1 July 2009 'to improve the horizontal equity in the tax system by treating all forms of remuneration more consistently, to target ESS 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'.[2]

The new rules (in Division 83A of the ITAA97) largely replicated Div 13A's provisions but they also introduced some significant changes (and were, incidentally, expected to generate $135 million in additional revenue over the forward estimates). They were criticised for the complexity they introduced and, at a practical level, they also impacted negatively to the subsequent take-up of, and participation in, employee share schemes in Australia.

As a consequence, in December 2013 the newly elected coalition government announced that, in response to industry concerns, it would reconsider the taxation and regulation of ESS as part of its focus on measures to encourage innovation. It later undertook to reform them as part of its 2014 *Industry Innovation and Competitiveness Agenda*.

The reforms, which came into effect on 1 July 2015, reversed some of the 2009 changes, introduced a further tax concession for employees of some start-up companies and provided measures to streamline the process for establishing and maintaining an ESS.

This paper examines those changes, evaluates the extent to which they have effectively addressed the problems with the 2009 provisions and considers what additional reforms may be desirable.

How Employee Share Schemes Work

Employee Share Schemes can work in a number of ways.

First, there can be an immediate right for employees to participate by purchasing shares, usually through some mechanism designed to provide them with an effective discount to market price and, often, involving a salary sacrifice arrangement to enhance the number of shares they can acquire. Such schemes usually involve the issue of shares to, or purchase of shares by, an Employee Share Trust which may or may not then hold them on the employees' behalf until some later vesting date.

---

[2] Explanatory Memorandum to the *Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009* at para. 1.15

Alternatively, employees may receive an option to acquire shares in their company at a fixed or determinable price at some time in the future with either the right to the options themselves or the right to exercise those options often being dependant on the employee meeting specified hurdles. This is particularly so with executive share plans where the exercise right may be dependent on the achievement of nominated corporate objectives such as profit or share price targets or a range of other readily quantifiable measures of corporate performance.

The option alternative is also widely used in small to medium, particularly start-up, companies to compensate key employees for the lower salaries and greater uncertainty regarding continuity of employment that working for such companies usually entails. In either case such schemes are technically not employee share schemes but employee share option plans.

The Regulation of Employee Share Schemes

Employee share schemes are regulated by two sets of laws – the companies legislation (dealing with the way in which such share schemes must be administered including facilitating them by waiving requirements such as the prospectus requirements that generally apply to share issues[3]) and taxation legislation (mainly the Income Tax Assessment Acts but also, potentially, the Fringe Benefits Assessment Act).

The Taxation of Employee Share Schemes Before 2009

While the receipt of any benefit as a consequence of employment can be seen as income from personal exertion and, therefore, taxable as ordinary income (or, alternatively, as a taxable fringe benefit), any discount to market value that an employee received on the acquisition of shares or rights to acquire shares has always been treated (and taxed) under specific (and separate) rules.

Before 1974 the value to the taxpayer of the discount was taxed simply as a 'benefit' under ITAA1936 s 26(e) (now ITAA97 s 15-2). The difficulty with this was that s 26(e) brought the 'value' of that benefit into assessable income even if it was conditional or did not really arise until some point in the future. This was made clear in *Donaldson v FCT* [1974] 1 NSWLR 627; (1974) 23 FLR 1 where the Commissioner's contention that the taxpayer had 'derived income' when he was granted options to acquire shares in his employer, Hooker Corporation Ltd, under an employee incentive scheme, was upheld even though the options could not be exercised until specified

[3] The *Corporations Act 2001* (Cth) provides a wide range of relief for Employee Share Schemes from the requirements that normally apply to an issue of securities. These include relief from the normal prospectus or other disclosure document requirements (disclosure relief), the requirement for those involved to obtain an Australian financial services (AFS) licence (licensing relief), from the prohibition on advertising or publicity before an offer or intended offer is made (advertising relief) and from the prohibition on the issue or sale of financial products arising out of unsolicited contact with employees (hawking relief).

times in the future and were conditional on the taxpayer remaining in the company's employ in the intervening period (a standard 'golden handcuffs' requirement).

The Court held that the options, being in the nature of a bonus or addition to salary, were of an income character and, therefore, that their 'value to the taxpayer' was immediately assessable under s 26(e) of the *Income Tax Assessment Act 1936* (Cth).[4] It also found that that 'value' could be ascertained by determining 'what a prudent person in [the taxpayer's] position would have been willing to give for the rights rather than fail to obtain them'[5] and, because the taxpayer bore the onus of showing that the Commissioner's assessment of that value was excessive but had not demonstrated either that it was wrong or that some other figure should be substituted for it, the Commissioner's assessment was upheld.

The government responded by inserting a new s 26AAC into the *Income Tax Assessment Act 1936* (Cth) to provide a specific provision under which employee share scheme discounts connected with services rendered by an employee (or by non-employees but in a similar capacity) could be taxed.

Section 26AAC provided that the appropriate taxing point for options[6] was when the options were exercised and converted to shares, not when they were received. Its effect was therefore to include the value (as at the date of acquisition) of shares that were acquired under an ESS as the result of exercising an option, less the costs of acquisition, in the recipient's assessable income in the year in which the shares were actually acquired. Consequently, unless a right to acquire a share was either exercised or sold the employee did not become liable to tax.

For schemes involving a direct issues of shares at a discount (ie not pursuant to the exercise of a previously acquired option) the taxing point remained the year in which they were acquired – though, from 1988, if they were issued to employees or directors and were subject to conditions or restrictions which limited the recipient's right to dispose of them, or were liable to be divested, they were deemed to be acquired if and when those conditions or restrictions ceased to apply.

When capital gains tax was introduced in 1985 two additional alternative concessions (which were only available to employees or directors – not associates) were introduced – a tax deferral option which allowed the holder of shares that were acquired after 19 September 1985 to elect to be assessed in the year the shares

---

[4] The finding that they were of an income character was necessary because it had earlier been held that s 26(e) only applied to items of an income nature (see Fullagar J in *Hayes v Federal Commissioner of Taxation* (1956) 96 CLR 47 at 54 and Windeyer J in *Scott v Federal Commissioner of Taxation* (1966) 117 CLR 514 at 525-6).

[5] *Donaldson v FCT* [1974] 1 NSWLR 627 at 644; (1974) 23 FLR 1 at 21 (citing *Pastoral Finance Association Ltd v The Minister* (1914) 15 SR (NSW) 535 at 540; [1914] AC 1083 at 1088).

[6] For shares the taxing point remained the year in which they were acquired under the scheme – though shares which were issued subject to conditions or restrictions which limited the employee's right to dispose of them, or which were liable to be divested, were deemed to be acquired if and when those conditions or restrictions ceased to apply.

were actually acquired instead of in the year they were deemed to be acquired (when any conditions or restrictions on their disposal ceased to apply), and a tax exemption option which allowed the first $200 of any discount to be excluded from the employee's assessable income each year.[7]

Section 26AAC continued to apply until Div 13A, another regime specifically designed to tax the discount at which shares or other interests were issued under an ESS, but in a way that prevented the exploitation that had occurred under s 26AAC – and which was also better aimed at ensuring that the tax concessions were directed at schemes that were broadly available to, and which encouraged, all permanent employees to invest in their employer - was enacted to replace it in March 1995.

From 1995 until 2009, how employees were taxed on the discounts they received on shares, stapled securities, or rights (including options) to acquire such shares or stapled securities (ESS interests) under the new Division 13A depended on whether the scheme in question operated inside (as a 'qualifying share scheme) or outside (as a non-qualifying share scheme) its concessional provisions[8] and, if it operated inside those provisions, whether the employee elected the tax deferral or the tax exemption option.[9] The default position, for both shares and rights, was that the taxing point was the year of acquisition – thereby maintain the s 26AAC position for shares but reinstating the pre-s 26AAC position for rights.

The incentive to operate outside the Div 13A concessions by including the market value[10] of the discount in assessable income in the year in which the interests were

---

[7] This also had the effect of reducing the cost base of the shares by an equivalent amount. This concession was also further amended in 1988 so that it only applied where the shares involved were ordinary shares, where the scheme required that any interest acquired could not be disposed of within 3 years of its acquisition unless the employee ceased employment (unless the interest was a right and it was disposed of by exercise) and where the scheme was limited to permanent employees only but was open to all permanent employees with at least 12 months service and applied equally to all of those employees.

[8] Div 13A applied to the acquisition of a share or a right to acquire a share after 6pm in the ACT on 28 March 1995. For stapled securities the provisions applied to acquisitions on or after 1 July 1996. The Division only applied however if the six conditions set out in the then ITAA 1936 s 139CD applied. These included a requirement that at the time the employee acquired the share at least 75% of the permanent employees of the employer were, or at some earlier time, had been entitled to acquire shares or rights under either that scheme or shares or rights in the employer or the employer's holding company under another employee share scheme (though the Commissioner had power to overlook non-compliance with this condition if he considered that the employer had done everything reasonably practicable to ensure that it had been satisfied – s 139CD(8)).

[9] The premise underlying Div 13A was that the any discount (generally the difference between the market price at the time the discount was included in the taxpayer's assessable income and the consideration paid for the interest) that a taxpayer received in relation to the acquisition of a share or other ESS interest under an employee share scheme was included in his or her assessable income in the year in which the share or other ESS interest was received but, if the interest received was a 'qualifying' interest, the taxpayer was entitled either to defer the inclusion of the discount for up to 10 years or, at the employee's election – the concession did not apply to directors - to have the discount included in his or her assessable income in the year the interest was acquired but have the first $1000 of the discount exempted.

[10] The specification of market value was designed to ensure that the amount of the discount could be objectively determined. For unlisted companies with illiquid shares this did however create a valuation

acquired - the default position provided under ITAA 1936 s 139B – or to choose the tax exemption option under s 139E - was to allow any increase in the value of the interests obtained under the scheme to be taxed under the capital gains tax provisions instead of under the income tax provisions that automatically applied to any increase in the value of the shares or rights being acquired before the 'cessation time'[11] if the tax deferral concession applied[12] - something which became an even more important consideration after the discount capital gains tax provisions were introduced in September 1999.

Of the two permitted concessions tax deferral was the default position in that, for qualifying employee share schemes, it applied unless the employee elected the tax exemption option instead. It allowed the inclusion of the discount in assessable income to be deferred, for up to 10 years, until the year in which the 'cessation time' occurred.[13]

It was most attractive to executives who were able to take significant parts of their remuneration in the form of shares, stapled securities or other ESS interests – and defer the payment of tax on those equities for as long as possible. This was especially so if they were able to acquire such interests through salary sacrifice arrangements which allowed them to be acquired with pre-tax as opposed to post-tax salary (with the result that the employee could generally acquire almost double the number of equities - with the resulting benefit of a greater compounding of any share price rises that applied thereafter and, of course, additional dividend entitlements on the additional shares that could thereby be acquired). If the shares were held for more than 30 days after the 'cessation time' any increase in their value during that part of the holding period was then taxed under the CGT provisions.

The tax exemption option, on the other hand, was most attractive to general employees whose annual participation in such schemes was usually limited to relatively small parcels of shares with taxable discounts typically not exceeding $1000. If the employee made the required election he or she became liable to pay tax on the benefit (the discount at which the shares or other interests were issued) in the year in which the benefit was received, but, provided the 'exemption conditions'

---

problem (with cost and administrative complexity consequences) which has still not been resolved in an entirely satisfactory way.

[11] See n 13 below

[12] The effectiveness of such schemes in achieving that outcome in every case was called into question in TR 2010/6 which, dealing with loan-based employee benefits trust arrangements, noted that the proceeds would normally fall within the income provisions in ITAA 1997 ss 6-5 or 15-2 or, if not, could be caught by either Part IVA or the FBT provisions.

[13] The 'cessation time' depended on whether what was acquired were shares, rights or stapled securities. For shares if there were no restrictions on disposal and the scheme did not have conditions that could lead to the share being forfeited the cessation time was the time of acquisition (with the result that there was no deferral of the taxing point for the discount). In all other cases the cessation time was when the share was ultimately disposed of or the later of the time when any disposal restrictions or forfeiture conditions expired, when the employee's employment ceased or 10 years after the share was acquired. Similar provisions applied to rights to acquire shares.

in then s139CE[14] were satisfied, the first $1,000 of the discount[15] was excluded, thereby, in most cases, eliminating any tax liability. When the shares were ultimately sold any post-acquisition increase in value was taxed under the CGT provisions and, after 21 September 1999, could be subject to the 50% CGT discount.

The 2009 amendments

The introduction of Div 83A into the ITAA97 in 2009 can only be properly understood in the context of the times. It was introduced in a period when there was concern about escalating executive remuneration and one of the express reasons given for its introduction was to reduce opportunities for tax evasion and avoidance and, thereby, to protect Commonwealth revenues in a period of global recession[16] (though it was also expected that it would generate some $135 million in additional revenue over the 2010-2013 forward estimate period[17] – mainly through the Division's new ESS Reporting Regime the effect of which was to better identify both employees who received benefits and the nature and amount of those benefits).

Despite this, Div 83A effectively replicated many for the concession provisions of the former Div 13A (which was repealed at the same time) – though it also introduced a number of new measures that were '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'.[18]

---

[14] Section 139CE required that the scheme not have any conditions that could result in the shares or rights being forfeited, that recipients not be permitted to dispose of a share or right acquired under the scheme for three years after it was acquired (or ceased employment) and that the scheme operate on a 'non-discriminatory basis' (as defined in s 139GF).

[15] The exemption was originally $500 but it was increased to $1000 in 1997 to 'broaden access to and increase the benefits of participation in employee share schemes' – see *Taxation Laws Amendment Act (No 1)* 1997, Sch 3.

[16] Explanatory Memorandum to the *Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009* at paras 1.14 and 1.15. Of specific concern were instances that the ATO had identified through its compliance monitoring programs of executives and directors failing to pay tax associated with employee share schemes by (a) attempting to retrospectively elect to be taxed upfront; (b) failing to include the value of the discount at the cessation time; or (c) incorrectly applying the capital gains tax rules to the discount on the Div 13A shares or rights instead of including the discount in their assessable income: see *'Employee Share Scheme Arrangements'*, Treasury Submission to the Economics References Committee, July 2009. The 10 year maximum deferral period had also caused concern because it provided directors and senior executives, who were usually able to ensure that the deferred taxing point did not occur prior to the expiry of the 10 year maximum (ie they could ensure that they did not exercise or dispose of the rights - or cease employment - during that time) with an incentive to defer their tax liability for the full 10 years.

[17] Explanatory Memorandum to the *Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009* at p.7

[18] Ibid para 1.15. These measures included changing the taxing point (and the conditions that had to be met to defer liability to tax), changing the conditions for exemption, and extending the operation of the Division to encompass past and prospective employees, subsidiaries of the employer company, corporate limited partnerships, corporate unit trusts and public trading trusts.

Consistent with the former Div 13A position, Div 83A first specifically exempted 'ESS interests' acquired under an employee share scheme from FBT.[19] Also consistent with the former s 139B it then provided that, generally, any discount to the market value of ESS interests acquired under an employee share scheme would be included in the employee's assessable income in that year – so its default effect was that the discount was taxed upfront, at the point of acquisition.[20] There was however a $1000 tax exemption for taxpayers with an adjusted taxable income[21] of $180,000 or less – which, again, applied provided the employee and the scheme met certain specified conditions.[22] One of these was that the employee could not, as a result of participating in the scheme, acquire a cumulative beneficial interest in more than 5% of the shares in the company or be in a position to cast, or control the casting of, more than 5% of the votes at a general meeting.[23]

A deferral option was also provided though, unlike the situation under the former Div 13A, whether it applied depended entirely on the structure of the scheme rather than on an election by the employee. For the deferred tax rules to apply the ESS interests either had to be acquired at a discount under an employee share scheme, had to relate to ordinary shares and had to be subject to a real risk of forfeiture[24] or, alternatively, had to be acquired at a 100% discount under a salary sacrifice arrangement where the employee was limited to acquiring no more than $5000 worth of shares (it did not apply to rights) in an income year.

A number of other conditions also had to be met for the deferral option to apply including that the scheme had to be 'broadly available' – which was defined in s 83A-105(2) to mean that at least 75% of the employer's permanent employees who had completed at least 3 years of service[25] and who were Australian residents had to be entitled to acquire ESS interests either under that scheme or under another employee share scheme operated by the employer or an associate.

For schemes that qualified for deferral of the taxing point there was also, as had been the case with Div 13A, a limit to the point to which the liability could be deferred. The restrictions were, however, substantially increased under Div 83A. Under ss 83A-115 and 83A-120 the 'ESS deferred taxing point' was the earliest of the times when any risk of forfeiture or restriction on disposal of the ESS interest

[19] ITAA 1997 s 83A-5 and FBTAA s 136(1) definition of 'fringe benefit' paras (h) and (ha).
[20] ITAA 1997 s 83A-25
[21] The sum of the taxpayer's taxable income (including the full amount of the discount and ignoring the possible exemption), reportable fringe benefits total, reportable superannuation contributions and total investment loss – see s 83A-35(2)
[22] ITAA 1997 s 83A-35.
[23] ITAA 1997 s 83A-35(9).
[24] Defined in s 83A-105(3) as a real risk that under the conditions of the scheme the employee would forfeit or lose the ESS interest (other than by disposing of it or in the case of rights to acquire shares, by exercising the right or allowing it to lapse).
[25] Under Div 13A the 3 year service qualification requirement had only applied to shares, not rights, and the effect of this extension was to restrict the application of the deferral concession for rights not only to directors but also to employees generally.

ceased to apply, when the employee ceased employment or 7 years after acquisition of the interest.[26] The new provisions also removed two of the Div 13A deferred taxing points that were within the employee's control (disposal or exercise of a right) so that the deferred taxing points that remained (other than cessation of employment) all related to occurrences outside the employee's control.[27] Collectively, these changes severely limited an employee's ability to defer his or her liability to tax.

He only real benefit of the new rules was that, once an ESS interest received under an employee share scheme was taxed, any subsequent increase in value was taxed in the same manner as any other capital assets – so generally it was taxed under the CGT provisions.

The changes that were introduced by Div 83A can be summarised as follows:

a. it introduced an income test for the existing $1000 tax exemption – restricting its availability to taxpayers whose adjusted taxable income was less than $180,000 (designed to target the concession at promoting the availability and take-up of employee share schemes among low and middle income employees);
b. it removed the employee's option to defer the taxing point (a change intended to reduce compliance risk and improve visibility of recipients for the Tax Office) and replaced it with a tax deferral which was dependent on there being either 'a real risk of forfeiture' (which was defined in terms of whether a reasonable person would conclude that there was 'a real risk that the share or right will not come home to an employee at a particular time and thus may be forfeited'[28]) or the scheme being based on a salary sacrifice arrangement with individual employees being limited to a maximum of $5000 worth of shares per year, there being no risk of forfeiture and the scheme's governing rules clearly distinguishing those schemes from those eligible for the upfront exemption;
c. where deferral was possible under the new rules because there was a real risk of forfeiture the taxing point was changed from those that had applied under Div 13A to the earliest of the time when there was both no longer a real risk that the share or right would be forfeited and no restriction on the employee's right to dispose of the shares or rights (or, in the case of rights, to exercise them), when the employee ceased employment or 7 years after the employee acquired the interest.[29] The amount to be included in assessable

[26] This was subject to the '30 day rule' under which, if the employee disposed of the ESS interest within 30 days of the originally determined ESS deferred taxing point, the ESS deferred taxing point became the time of actual disposal instead: see ITAA 1997 ss 83A-115(3) and 83A-120(3).
[27] See n 15 above.
[28] '*Employee Share Scheme Arrangements*', Treasury Submission to the Economics References Committee, July 2009 p 5
[29] ITAA 1997, s 83A-115

income at that point was the market value of the ESS interest at that point reduced by its cost base.[30]

d. a number of integrity rules were also introduced – including a new annual reporting requirement for employers that offered employee share schemes requiring them to report the number of shares and rights an employee obtained both at grant and at the taxing point[31] together with a limited withholding requirement in cases where the employee has not provided the employer with a TFN or ABN.[32] Where the ESS interest was provided not to the employee but to an associate it was treated as though it had been acquired by the employee (to prevent leakage of revenue if the associate was subject to a lower marginal rate of tax);
e. revised regulations were introduced for the valuation or shares or rights not listed on the stock exchange (because of concerns that the existing valuation rules led to under-valuation)[33]; and
f. employee share schemes had to be approved by the ATO and APRA before qualifying for concessional tax treatment.

Problems with the 2009 Amendments

In many respects Div 83A was a sledge hammer used to crack a nut. While it reduced the opportunities for tax evasion and avoidance, it did so by reducing the attractiveness and, therefore, the extent to which employee share schemes were used[34] – thereby depriving the economy of the benefits that such schemes can confer.[35] It also did so in a way that increased both the administrative complexity involved in establishing and maintaining such schemes (the complexity of the

[30] ITAA 1997 s 83A-110(1)

[31] *Taxation Administration Act 1953* Sch 1 Div 392

[32] *Taxation Administration Act 1953* Sch 1 Subdiv 14-C

[33] See Income Tax Regulations 1997 regs 83A-315.01 to 83A-315.09

[34] In the Employee Ownership Australia and New Zealand April 2013 Report (n 37 below) it was noted (at p 6) that the introduction of Div 83A had had a significant impact at the broad based employee participation level with 'over 90% of plans [being] suspended during the first year and 30% of plans [being] suspended for up to two years. Of the 30% of plans suspended for two years many have not been reinstated'. It also noted that 'The $5000 salary sacrifice limit imposed under Div 83A has had the greatest impact on broad based employee groups, middle management and employee savings plans. There has been a noticeable decline in the amounts that are contributed to salary sacrifice employee share ownership plans as a direct result of the provisions in Div 83A and, in particular, the $5000 cap' and that 'Overall, the number of employees participating in, and the amount invested by employees in, employee share ownership plans has substantially reduced since the introduction of Division 83A'. These assertions were acknowledged in The Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* (at p 33) but with the comment that 'there is no readily available data to quantify these claims'

[35] For a discussion of the link between ESS and improved productivity and corporate performance see '*Employee Share Schemes – Their Importance to the Economy',* Employee Ownership Australia and New Zealand Expert Panel Report, July 2014, pp 9-11. The same report also discusses the benefits to employees when compared to investing the same amounts in the All Ordinaries Index or using it to make accelerated payments on their standard home loan.

required valuation methodology for options being a particular problem)[36] and compliance costs.[37]

A major problem for all ESS arose because the 2009 changes moved the taxing point for options (at least where there was no risk that they would be forfeited) to when they were provided rather than when they were exercised (ie to a point before which the employee could generally realise any gain in order to pay the tax)[38]. This effectively killed off the provision of options under employee share schemes, especially for start-up companies.[39] One obvious consequence of this was that start-ups that had used such schemes in lieu of higher salaries found it increasingly difficult to attract the employees they needed and, in some cases, that contributed to them relocating overseas.[40]

Even where companies retained their presence in Australia the change in the taxing point effectively forced them to 'expend considerable time and financial cost in restructuring employee equity plans'.[41]

Unlisted start-ups that did continue to offer ESS also had problems with both valuation and liquidity. Because they were unlisted there were difficulties in determining valuations effectively and, because there was not a ready market for their shares, it was often difficult for employees to dispose of their shares to pay the tax on the benefit.[42]

There was also added complexity and cost for international companies that had previously offered their Australian employees options to acquire shares in an

---

[36] This was a particular problem in relation to the company valuations that were required when shares or options were issued (with possible multiple valuations being required each year). The Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* (at p 32) noted that 'Stakeholders have advised that this can cost as much as $50,000 per valuation in Australia, compared, for example, with the United States where the cost is US$2000 to US$5000'.

[37] One of the reported consequences of the changes was that nearly all companies found it necessary to review and revise their existing ESS arrangements with many introducing new plans and/or amending their existing plans. The review process involved significant cost and often resulted in companies having to operate more plans than they had prior to the changes. That too added to complexity and cost without necessarily translating into greater employee participation. See *'The Changing ESS Landscape since 1 July 2009'*, Employee Ownership Australia and New Zealand (EOA) Report, April 2013 pp 11-12.

[38] For those plans that did continue this also had the effect of defeating one of the major objectives behind the encouragement of ESS – to give employees 'skin in the game'. By advancing the taxing point employees often found that they had to dispose of their shares in order to meet their tax liability instead of retaining them as long-term investments.

[39] In its July 2014 Report, '*Employee Share Schemes – Their Importance to the Economy'* the Employee Ownership Australia and New Zealand Expert panel noted (at p 3) that 'Pre 2009 85% of start-up/growth sector companies used option plans. Post 2009 this number dropped to 6%'.

[40] Industry and Innovation Agenda - An Action Plan for a Stronger Australia, Department of Prime Minister and Cabinet 14 October 2014, p 77.

[41] *'The Changing ESS Landscape since 1 July 2009'*, Employee Ownership Australia and New Zealand (EOA) Report, April 2013 p 6.

[42] There was also a problem in that, if the start-up failed, the employees would have been required to pay tax on something with no realisable value.

overseas listed parent with the consequence that there was a decline in the number of international plans being offered to Australian employees. This adversely affected Australians employed in those companies by denying them the opportunity to participate in those schemes and also adversely affected the companies by compromising their ability to offer their Australian employees competitive remuneration packages.[43]

The problems with the change in the taxing point for options was also exacerbated by the effective elimination of tax refunds for options that had vested (and therefore which had been subject to tax) but which were 'out of the money' at the exercise time.[44]

Even for schemes that qualified for deferral of the taxing point the retention in s 83A-115 of cessation of employment as one of those possible 'ESS deferred taxing points' created problems where the right to acquire those shares had either not then vested or, alternatively, was 'out of the money'.[45] This had been a concern with the equivalent provision in Div 13A (in that it too taxed unrealised awards) but, despite lobbying, it was not addressed in the 2009 changes (if anything, it was made worse as a result of the new Division's limited tax refund provisions).

Finally, the change in the disposal restriction that eligible ESS had to include in their rules made salary sacrifice plans less attractive to employees. Under the former Div 13A there had been a restriction condition that operated during the then possible maximum 10 year tax deferral period. However, even though 85% of employees did not seek to access their shares during that period there was a degree of flexibility in the legislation and access was possible. Under Div 83A the required disposal restriction had to apply from the date of the offer and could only be removed in extreme cases such as financial hardship or special circumstances. This made participation in ESS less attractive and resulted, in practice, in companies limiting their restriction period to the minimum 3 years required. It also led to a majority of participants selling their shares at the end of that period in order to fund their tax liability.[46]

The 2015 Changes

The tax treatment to which employee share schemes were subject following the 2009 amendments caused considerable concern and when the new coalition

---

[43] *'The Changing ESS Landscape since 1 July 2009'*, Employee Ownership Australia and New Zealand (EOA) Report, April 2013 p 7.

[44] Ibid. Under ITAA97 s 83A-310 a refund of tax paid was available but only where the interest was forfeited otherwise than as the result of a choice by the employee (other than a choice to cease the employment) or of a condition of the scheme that had the direct effect of protecting (wholly or partly) the taxpayer against a fall in the market value of the interest.

[45] 'The Changing ESS Landscape since 1 July 2009', Employee Ownership Australia and New Zealand (EOA) Report, April 2013 p 7.

[46] '*Employee Share Schemes – Their Importance to the Economy',* Employee Ownership Australia and New Zealand Expert Panel Report, July 2014, p 5.

government was elected in September 2013 one of its first actions was to announce (on 18th December 2013) that it would focus on measures with the potential to encourage innovation and that these would include measures involving the taxation and regulation of employee share schemes.[47] Following that announcement there were some minor public consultations (for two weeks commencing on 28th January in Sydney and Melbourne with some teleconferencing for those unable to attend those meetings).

Drawing on those consultations, advice from the Prime Minister's Advisory Council and a study that the Business Council of Australia produced in July 2014, the Government released its *Industry Innovation and Competitiveness Agenda* on 14th October 2014 announcing, inter alia, that it would reform the tax treatment of ESS (defined as schemes under which, as a consequence of their employment, employees - or their associates[48] - receive shares, stapled securities, or rights (including options) to acquire them (ESS interests)).

The proposed reforms were designed 'to bolster entrepreneurship in Australia and support innovative start-up companies',[49] 'to make Australia's taxation of ESS interests more competitive by international standards and to facilitate the commercialisation of innovative ideas in Australia … to assist innovative Australian firms to attract and retain high quality employees in the international labour market'[50] and to reduce 'the compliance burden faced by small businesses and … make it easier and cheaper for businesses to set up and maintain an ESS'.[51]

In particular the stated aims of the proposed reforms were:

- 'For all companies, … to ensure that they remain internationally competitive and reduce disincentives for employers and employees to participate in ESSs.
- For start-ups, … to minimise complexity and compliance costs associated with the tax law, and increase the incentives for the start-up sector to use ESSs'.[52]

In summary the effect of the 2015 changes is that:

---

[47] The previous Labour government had commenced the process, particularly in relation to the impact of the 2009 changes on start-ups (see *Advancing Australia as a Digital Economy: An Update to the National Digital Economy Strategy,* 12 June 2013) but it was carried through to implementation by the incoming coalition government.

[48] Both Div 13A (s 139D(1)) and Div 83A (s 83A-305) had provided that where an ESS interest was acquired by an associate of the employee, the employee was taxed on the value of the discount as if he or she had received it. This was to ensure that there could be no tax advantage in the employee directing that the interest be provided to an associate with a lower marginal tax rate.

[49] Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* para 1.4

[50] Ibid at 1.5

[51] Ibid at 1.6

[52] Ibid at pp 33-34

a. the default position remains that benefits from the provision of shares or options under an employee share scheme are taxed upfront when the shares or options are provided;
b. however employees participating in option schemes can more easily defer their liability to taxation until when the options are exercised and, in particular, without the options having to be at risk of forfeiture – though the scheme rules are still required to state that the tax deferred treatment applies to the scheme and the scheme must genuinely restrict the employee from immediately disposing of the rights he or she acquires;
c. while still not permitting unlimited deferral of taxation liability, the permitted deferral period for ESS interests that are shares or rights has been extended from a maximum of 7 years from the time the shares or rights are acquired to a maximum of 15 years – mainly to allow start-ups more time to succeed and, therefore, for the value of the ESS interests to increase before they have to be disposed of to pay the tax liability. The 'ESS deferred taxing point' does however continue to include the earliest of when there is no real risk of forfeiture of the interest and any restrictions on sale are lifted and when the employment ceases;
d. the exemption from taxation of the first $1000 of ESS interests provided to employees who earn less than $180,000 has also been retained;
e. the integrity measures that were introduced in 2009 have largely been retained – though the refund provisions have been relaxed a little so that a choice by an employee not to exercise a right or to let a right be cancelled does not now prevent the refund provisions applying (provided the scheme has not been structured to directly protect the employee from downside market risk);
f. the Commissioner is to work with industry to develop and approve (by either legislative instrument or regulation) safe harbour valuation methods to improve certainty and reduce compliance cost and, to that end, has been given a new power to approve market valuation methodologies. Approved methodologies are binding on the Commissioner but taxpayers may choose another methodology if it is more appropriate to their circumstances;
g. the government also committed the ATO to work with industry and ASIC to develop and approve standard documentation (to be issued under the Commissioner's general powers of administration) to streamline the process of establishing and maintaining an ESS;
h. options and shares that eligible small start-up companies[53] issue to their employees at a small discount may be eligible for a 'start-up concession' under which the employee does not include the discount in assessable income (so they are not subject to up-front taxation) provided the interests are, generally, held by the employee for at least three years. They are instead

[53] To be eligible the start-up must have a turnover of not more than $50 million, must be unlisted and must have been incorporated for less than 10 years.

treated as capital and tax is deferred until the share acquired on exercise of the right is sold with the time of acquisition for CGT discount purposes being the time the right was acquired not when it was exercised and the share was acquired.[54]

i. the significant ownership and voting rights limitations that were introduced in 2009 to prevent employees misapplying the concession in order to buy a business or indirectly access company profits through the ESS have been relaxed by doubling the existing 5% ownership and voting rights limitation to 10%. The result is that employees can now have a greater ownership share in their employer without breaching the restriction (though not to such an extent that that the benefits of the ESS cannot be spread widely among employees or that the fairness or integrity of the tax system is put at risk by facilitating misuse of ESS arrangements). This can be especially important for small start-ups in the early stages of their development when they have limited numbers of employees and a 10% interest in the company may be worth comparatively little.

Have the 2015 Changes Achieved their Purpose?

The extent to which the amended rules have achieved their purpose can really only be determined once the new regime has been tested in the workplace. To the extent that they do result in an increased use of employee share schemes, both generally and in start-ups, they will have, at least partially, achieved their purpose.

There are some clear positives, the major ones being the reintroduction of the option for employees to defer the taxing point to a more realistic time as a generally available entitlement.

The retention of the ESS Reporting regime which gave the ATO better visibility of the operation and extent of ESS (and, arguably, was all that was really needed to address the problems of avoidance and evasion that were identified as the major issues that the 2009 reforms were designed to address[55]) is sensible, especially as it also provides scheme participants with certainty and transparency regarding the quantum and timing of taxable events and has helped them understand the tax consequences of participating in the schemes.[56]

The new small start-up concession is also a significant development and can only assist with advancing the nation’s Innovation and Competitiveness Agenda.

There are however still some residual problems:

---

[54] The small start-up concession is a standalone concession and employees who use it cannot also use the $1,000 up-front concession or the deferred taxation concession.

[55] *’The Changing ESS Landscape since 1 July 2009’*, Employee Ownership Australia and New Zealand (EOA) Report, April 2013 p 5.

[56] ibid

a. Firstly, there is still the problem of cessation of employment remaining as an ESS deferred taxing point[57] – even if the vesting conditions have not then been satisfied or if the ESS interests are then 'out of the money' – especially when that is combined with the somewhat relaxed but still restrictive refund rules. It could have been either deleted as a deferred taxing point (being replaced with some other means of ensuring collection of the tax) - or its application could have been qualified in some way, such as by legislatively making cessation of employment a trigger for the plan to stop being restricted an action which would both facilitate collection of the tax and improve fairness.[58]
b. The $1,000 tax reduction limit has not been increased since 1997[59] so the real value of the concession has decreased significantly. One of the aims behind the 2009 amendments was to advance the time when tax was paid on ESS discounts. If that is still part of the aim, electing up-front taxation would be far more attractive if the real value of the concession was at least restored (or, preferably, increased) and with provision for regular increase into the future, through indexation or otherwise.
c. The concession could also have been made available to all employees, as it was until 2009, and not simply to those with an adjusted taxable income of less than $180,000.
d. If the $180,000 cap is to be retained it should at least be made subject to some form of automatic escalation – whether by alignment with changes to the top marginal tax rate threshold, by indexation to AWOTE or CPI, or otherwise, to preserve its true value and to prevent bracket creep excising otherwise qualified employees from participation in the schemes.
e. While the introduction of the small start-up concession is a significant development the limitations on companies eligible to access it – while explicable for the reasons set out in the Explanatory Memorandum (essentially to 'ensure that the concession is appropriately targeted to genuine Australian start-up companies)[60] - do, arguably, unnecessarily constrain the achievement of the government's stated aims of bolstering entrepreneurship in Australia and supporting innovative start-up companies.[61] For example, it does not extend to listed companies - so start-ups that choose to list in order

---

[57] Cessation of employment was originally introduced as a taxing point before the introduction of Div 83A's reporting regime because of concerns about employees leaving the jurisdiction post-employment but before vesting – thereby creating potential collection problems. Its application was not however restricted to such employees: '*Employee Share Schemes – Their Importance to the Economy',* Employee Ownership Australia and New Zealand Expert Panel Report, July 2014, pp 6-7.
[58] For a discussion of the potential problems arising from cessation not being a vesting event see '*Employee Share Schemes – Their Importance to the Economy',* Employee Ownership Australia and New Zealand Expert Panel Report, July 2014, p 7.
[59] See n 15 above
[60] Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* paras 1.72-1.79
[61] Ibid at para 1.4

to obtain capital through a public offer cannot qualify for the concession.[62] Nor can companies that increase turnover – but not necessarily available profit – to more than $50 million.[63] The necessity to reinvest could still constraint the ability of such companies to pay the salaries that concessionally taxed ESS were designed to replace, while the turnover limitation could restrict them from offering such schemes at precisely the point in their development where they were most needed.

f. Similarly, the requirement that the scheme must be 'broadly available' to qualify for the start-up concession should be clarified to ensure that it does not preclude participation by 'true' start-ups (those that have only recently been formed). The requirement is defined in s 83A-105(2) to mean that the scheme must be available to at least 75% of the company's Australian resident, permanent employees who have completed at least three years of service - but 'true' start-ups will have no employees of three years standing at that time. *Interpretive Decision* ID 2003/24, which applied to the equivalent provision under Div 13A, seems to indicate that this would not prevent the concession applying (because 75% of zero is zero so the requirement would always be satisfied) – though legislative clarification would be preferable.

g. There is also a misalignment of the taxation treatment of shares and rights under the start-up concession. While it can apply to shares issued to eligible employees at a discount of up to 15% to market value, deferring tax on rights is only possible if the rights' exercise price is greater than or equal to the market value of the company's ordinary shares at the time the rights were acquired.[64] If the intent is really to make it easier for start-ups to attract talent by offering participation in ESS, the rights option needs to be made considerably more attractive (especially given the possibility of the start-up failure).

h. Similarly, in a globalised economy with an increasing use of remote workforces it is difficult to understand why the concession should only apply to Australian resident employees.[65] If the aim is to permit start-ups to attract the best possible talent this limitation would seem to be an unnecessary constraint on their ability to do so.

i. There are still considerable administrative compliance and cost burdens associated with ESS which could have been further reduced (though perhaps the ATO's development of safe-harbour valuation methodologies and standard documentation for ESS will go some way to reducing those burdens).

Conclusion

[62] ITAA 1997 s 83A-33(2).
[63] ITAA 1997 s 83A-33(4).
[64] ITAA 1997 s 83A-33(5).
[65] ITAA 1997 s 83A-33(6).

There is overwhelming evidence that the 2009 changes to the taxation of ESS were largely counter-productive and, instead of protecting the revenue, they largely killed off the schemes which governments of all political persuasions had sought to encourage.[66] The 2015 changes have gone some considerable way to reinstating the attractiveness of such schemes (and extending new concessions when they are operated by start-ups) but there are still aspects of the taxation treatment which deserve further attention.

[66] Employee Share Ownership Schemes have operated in Australia since at least the 1950s (House of Representatives Standing Committee on Employment, Education and Workplace Relations, *Shared Endeavours – an Inquiry into Employee Share Ownership in Australia (Majority Report)* (2000) 9 [2.1]) in line with the then Prime Minister Robert Menzies' belief in the 'encouragement and introduction of profit sharing schemes wherever possible' (McElvaney, J and Waddel, D, *The Employee Share Ownership Plan: what value has it for Australia?* in Kennedy, J and Di Milia, L (eds), *ANZAM 2006: Proceedings of the 20th Annual Conference of the Australian and New Zealand Academy of Management*, pp. 1-14, Australian and New Zealand Academy of Management, Lindfield, NSW.