

TAXATION OF



EMPLOYEE SHARE SCHEMES



WealthAdviser

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Before you get started

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Information in this handbook is no substitute for professional financial advice.

We encourage you to seek professional financial advice before making any investment or financial decisions. We would obviously love the opportunity to have that conversation with you, and at the rear of this handbook you will find information about our authorised representative and how to go about booking an appointment.

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Letter from the Wealth Adviser Library

Dear Reader

Welcome to the Wealth Adviser Library

This library was built specifically to facilitate the provision of sound financial information to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of members who share our vision and commitment to providing tailored financial advice and a new foundation of financial understanding and security for everyone.

With a national network of likeminded experts, we have the potential to provide the financial building blocks for future generations.

Knowledge gives you a huge advantage

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of digital handbooks and manuals that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this publication and find it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

Take the next step

Wealth Adviser (a division of WT Financial Group Limited) supports more than 400 privately owned and operated advice practices around the country. We invite you to engage with one of our advisers to discuss what it was you were hoping to achieve when you obtained this handbook, and to establish if they can help you achieve your goals and objectives.

At the rear of this handbook you will find details on how to book an appointment.

Wealth Adviser Library

Introduction

Share schemes have traditionally been seen as one of the most important 'weapons' in the attraction and retention of quality staff. It is not difficult to figure out why this might be the case. By owning a bit of the company they work for, staff members are motivated by much more than the pay check at the end of the month. Add to this the significant monetary rewards that share holding employees can accrue by contributing to the success of their companies and you can see why the operators and beneficiaries of employee share schemes are generally quite positive about the outcomes that are being achieved. In fact, many companies see such schemes as a vital part of their overall remuneration strategy.

Not everybody views employee share schemes as welcome additions to the remuneration landscape however! Chief amongst the detractors is the Australian Taxation Office (ATO). It is not that the ATO would like to see such schemes scrapped. This would in any way be impossible, in a free society where companies can reward their employees in whichever way they see fit! The problem, from the ATO's perspective has more to do with how they can get their piece of the pie. The taxman correctly sees the receipt of shares as part of an employee's total income, but has always struggled to find a fair and equitable way in which this income could be taxed.

A quick note on terminology before we continue: Government documents constantly refer to the "discount for shares" when discussing the issue of employee share scheme taxation. This simply means that tax will be payable on the difference between market value and what an employee paid for the shares. In the case of shares that are handed out for free this 'discount' will obviously be 100% of market value.

The determination of market value will be discussed below.

Some major complicating factors in the taxation of company share schemes include:

Conditions:

Many share allowances come with stringent conditions attached. (e.g. shares may be withdrawn unless an employee serves a number of years or attain certain performance targets). Most employees will balk at the prospect of having to pay tax on assets when long term ownership is not 100% certain.

Value:

Fluctuation is a feature of share values. The obvious question arising from this basic fact is how the value of shares given to an employee should be determined for taxation purposes.

Level of taxation:

Most people tend to associate employee share schemes with super rich corporate high-flyers. The fact is, however, that many companies offer share ownership schemes to employees at every level of the corporate career ladder. This means that a formula is needed to ensure that company share packages are taxed at levels that are appropriate to the overall income of the recipients.

International competitiveness:

At executive level company shares are often seen as a core part of any remuneration package. This means that unfavourable tax regimes in this area can often be a deciding factor in convincing top executives not to take up a position in a particular country.

Please Note:

Tax law is, by its very nature, a very fluid area. The tax treatment of Employee Share Schemes (ESS's) has been a changing landscape over the years and a brief history is provided below.

This guide should therefore not be seen as the 'final word' on the matter of employee share scheme taxation.

Each ESS is different and it is very important that you are aware of the scheme's rules and understand what the tax implications are.

Background to the changes

It has been clear for a long time that the government was convinced that 'Caesar is not getting his due' when it comes to the taxation of company share schemes.

Previously, ESS's were taxed under Division 13A of the former Income Tax Assessment Act 1936 (ITAA 36) but rules were tightened from 1 July 2009 through the introduction of Division 83A of ITAA97.

These rules generally aimed to tax upfront the discount received to the market value of shares or options acquired under an ESS but were later seen to be inhibitive and discouraged the use of ESS'.

As a result, the government introduced legislation which applied from 1 July 2015 reversing some of the changes made in 2009 and introducing further tax concessions to benefit employees of certain small start-up companies.

These changes aimed to make Australia a more attractive investment destination for businesses, particularly for small start-up companies, allowing them to be more competitive in recruiting and retaining talented employees.

Hence, current ESS rules generally apply to all ESS interests acquired from 1 July 2009 and from 1 Jul 2015 under new rules. Transitional arrangements are in place for some ESS interests acquired prior to 1 July 2009, however, for the purposes of this eBook, we will focus on ESS interests acquired from 1 July 2009.

Tax exemptions

Where an employee pays tax upfront on the assessable discount received on their ESS interest, they may be eligible to receive a \$1,000 tax exemption providing the employee meets an income test and both the ESS and the employee meet specific conditions.

Employee Income Test

- A taxpayer's total taxable income, reportable fringe benefits, reportable employer superannuation contributions and total investment

loss must add up to or be less than \$180,000

Other Specific Conditions

- There must not be a real risk of forfeiture relating to the ESS interest
- The scheme must be offered in a non-discriminatory way to at least 75% of Australian resident permanent employees with three or more years of service.
- The scheme must be operated so that your employees must hold their ESS interests (or any share acquired as a result of exercising the interest)
- For a minimum of three years
- Until they end employment
- Satisfy the 5% ownership and voting rights test* immediately after acquiring the ESS interests between 1 July 2009 and 30 June 2015. From 1 July 2015, this percentage was increased to 10%.

* The voting rights test requires that after acquiring your ESS interests, you, as an employee must not hold more than the relevant percentage in ownership of the company or control more than that percentage of the voting rights of the company.

As mentioned earlier, since 1 July 2009, the taxation of ESS's are generally taxed upfront. However, tax deferred schemes are allowed where certain conditions are satisfied. The deferral of tax will be limited to two conditions, namely:

1. Salary Sacrifice –Tax Deferred Scheme
2. Real Risk of Forfeiture –Tax Deferred Scheme.

Salary sacrifice – tax deferred schemes

Tax is able to be deferred where an ESS interest is obtained under a salary sacrifice arrangement provided the following conditions are met:

- The ESS interests must relate to shares or stapled securities acquired under a salary sacrifice arrangement
- The employee must receive the shares for no consideration (i.e. the discount per share provided through the arrangement is equal to the market value of the share)
- The employee must receive no more than \$5,000 worth of shares (market value) per income year
- The governing rules of the ESS must state that deferred taxation applies to the scheme

The scheme must be offered in a non-discriminatory way to at least 75% of Australian resident permanent employees with three or more years of service.

Any rights under the scheme must be subject to a real risk of forfeiture (see below)

The setting up of eligible salary sacrifice schemes will obviously be the responsibility of the employer and the structure of the schemes will have to comply with the guidelines laid down in the Income Tax Assessment Act 1997.

Companies wishing to utilise salary sacrifice schemes would be well advised to seek specialist advice in order to ensure that the scheme complies with relevant legislation and regulations.

“Real risk of forfeiture – tax deferred schemes”

Where an ESS interest is at ‘real risk of forfeiture’, tax will be deferred until a deferred taxing point (see below). A real risk of forfeiture is whether a reasonable person would consider that there is a real risk under the conditions of the scheme that the employee would:

- In the case of shares, forfeit or lose the interest (other than by disposing of it)
- In the case of rights, forfeit or lose the interest (other than by disposing of it, exercising it, letting it lapse or through the market value of the ESS interest falling to nil).

There are a number of ‘real risk of forfeiture’ tests and these include the following:

1. Performance Hurdles

If the receipt of shares is linked to specific performance targets (e.g. increased sales, improvement of market share etc.) there is indeed a ‘real risk of forfeiture’ and the taxation point will be deferred until such targets have been met.

2. Minimum Term of Employment

Conditions of an ESS may provide for a minimum term of employment such. These may:

- Provide for a staged vesting of the rights (in the form of shares) at various periods of time after the date of grant (e.g. at the end of one year, two years and three years).
- Contain ‘good leaver’ provisions that allow an employee to retain their ESS interests in the event of death, invalidity, bona fide redundancy or retirement six months after the date of grant

Forfeiture or loss of your ESS interests

Where your ESS interests are forfeited or in the case of rights, forfeited, lapsed, expired or lost (where you have not exercised or disposed of it) and you included a discount in your assessable income, you may be entitled to exclude the discount and receive a refund of any tax paid in relation to those interests.

If you are entitled to receive a refund, you are treated as never having acquired your ESS interests.

Your tax return may be amended in the income year that the discount was received.

Note that there is no time limit for amending your tax return to exclude this amount from your assessable income.

Deferred taxing point

Where an employee receives shares or rights under a deferral arrangement, the taxation of company share schemes will be based on the market value at the deferred taxing point reduced by the cost base of the interests.

The deferred taxing point for a share, stapled security or rights is the earliest of the following times:

- When the employee ceases the employment they acquired the share, security or right in relation to;
- Seven years after the employee acquired the share, security or right if acquired between 1 July 2009 and 30 June 2015 or fifteen years if acquired from 1 July 2015.
- When there is no real risk of forfeiture and the scheme no longer genuinely restricts the disposal of the share, security or right
- In the case of rights, if acquired:
- Between 1 July 2009 and 30 June 2015, there is no real risk of forfeiting the right or underlying share, and the scheme no longer genuinely restricts exercise of the

right or disposal of the resulting share

- From 1 July 2015, when the right is exercised and there is no real risk of the employee forfeiting the underlying share and the scheme no longer genuinely restricts the disposal of the resulting share.

If the employee disposes of the ESS interest (or the share acquired on exercise of the right) within 30 days of the deferred taxing point, the deferred taxing point will then be that date of that disposal (known as the 30-day rule).

Valuation point

One difficulty in the past is that there were many unresolved issues surrounding the real market value of ESS interests, especially for start-up companies.

From 1 July 2015, the ATO was provided with the additional power to approve market valuation methodologies that can be used by taxpayers to comply more easily with the law.

Further information on approved market valuation methods can be found on the ATO website.

<https://www.ato.gov.au/General/Employee-share-schemes/In-detail/ESS--Safe-harbour-valuation-methods/>

Small start-up companies

From 1 July 2015, the government introduced tax concessions for employees of certain small start-up companies where certain conditions are met.

If shares are acquired in a start-up at a discount of up to 15% to that of market value, then the discount is exempt from income tax.

Where an ESS is a right, the amount that must be paid to exercise the right must be greater than or equal to the market value of an ordinary share.

Note normal capital gains tax rules will apply on disposal.

To be eligible for this concession, the

following conditions must also be met.

- The ESS interests must be in a start-up company
- Your company (which may not be the company issuing the ESS interests) must be an Australian resident tax payer
- The scheme is operated so that employees must hold the ESS interests (or any share acquired as a result of exercising that interest) for a minimum of either
- Three years
- Until your employees cease employment

Note that the small-start up concession applies to the exclusion of all other ESS rules. That is, the upfront \$1,000 exemption or the deferred tax concessions will not be available.

What is considered to be a start-up?

To be considered as a start-up company and be eligible for the small-start up concession, companies are required to:

- Be incorporated for less than 10 years
- Be an Australian resident company
- Have no equity interests listed on an approved stock exchange

Have an aggregated turnover of less than \$50 million.

Note that the Australian Taxation Office (ATO) have developed a set of standard document templates designed to assist eligible start-ups establish an ESS's. These can be found on the following link.

<https://www.ato.gov.au/General/Employee-share-schemes/In-detail/Standard-documents-for-the-start-up-concession/>

Employer responsibilities

From 1 July 2009, employers have been subject to additional reporting requirements.

Annual Reporting

Employers are required to report the provision of shares, stapled securities or rights (including options) to the Australian Taxation Office (ATO) and their employees under an annual reporting regime.

That this:

- An ESS statement is required to be provided to your employee by the 14th July after the end of the financial year
- An employee share scheme annual report is required to be provided to the ATO by the 14th August after the end of the financial year.

Furthermore, where there is any material change to the information provided to the ATO, they are required to be notified within 30 days of you as an employer becoming aware of this change.

Tax withholding:

If an employee has failed to provide a TFN or ABN, withholding tax will apply on the discount that your employer should have included in their assessable income (currently pegged at 45% + Medicare Levy + The Temporary Budget Repair Levy).

Conclusion

The taxation of employee share schemes has been a changing landscape with different rules operating depending on when any ESS interests are acquired.

Taking into account the added complexity that each ESS is different, it is very important that all stakeholders are aware of the scheme's rules and understand the relevant tax implications in order to plan their tax strategies accordingly.

Take the next step

We trust you enjoyed this publication and found it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

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We look forward to meeting you soon.

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Please nominate your preferred day, date and time to meet with us. One of our client services representatives will call you to confirm your appointment.

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