

EMPLOYEE SHARE SCHEME CHANGES – THE NEW ERA

Overview

A properly implemented Employee Share Schemes (“ESS”) can assist in incentivising and retaining key employees as well as aligning employee interests with those of shareholders. They are also an opportunity for employers to provide benefits to employees without requiring a cash outflow.

The current tax rules apply to shares and rights to acquire shares on or after 1 July 2009. There have been some subtle but significant changes to tax rules for ESS, and employers are now looking to see how best to structure new arrangements to ensure the optimal benefits for both employer and employee.

New Rules – Headlines in Brief

The key features of the new rules are:

- Employees are taxed on the receipt of shares or options (“ESS interest”) at a “discount” to their market value, i.e. market value of the share or option, less any consideration paid by the employee.
- Market value generally takes its ordinary meaning. However, unlisted options may be valued either using the actual market value (valuation required) or using calculation tables in the legislation. Different market value calculation rules apply where the employee disposes of the ESS interest within 30 days of their taxing point and affected employees should seek their own advice in this regard.
- Employees will generally be required to be assessed on the discount in the year in which the ESS interest is received (i.e. up-front taxation), unless the ESS plan qualifies for deferred taxation.
- Eligibility for deferred taxation depends entirely on the rules of the ESS plan. Employees no longer have the option to elect when they are taxed on receiving ESS interests under an ESS.
- To be eligible for deferred taxation, the scheme must meet numerous conditions, including:
 - The plan only entitles employees to receive or acquire ordinary shares
 - For an issue of shares, the scheme must be offered to at least 75% of the company’s Australian resident permanent employees
 - The employee must not have significant ownership or voting rights (<5% test)
 - The ESS interest must be subject to real risk of forfeiture in the hands of the employee;
- Under the deferred taxation rules, the discount is generally calculated as the MV of the ESS interest less any amount paid to acquire the interest at the time the deferred taxing point arises.
- The deferred taxing points are generally the earliest of the following times:
 - When the employee ceases employment with the employer;
 - Seven years after acquiring the ESS interest;

- When there is no longer any real risk of forfeiture and there are no longer any genuine restrictions on disposal or exercise of the ESS interest.
- The ESS interest is first taxed under the ESS rules, with a subsequent disposal taxed under either the CGT or ordinary income rules.
- The Rules apply to employees and those in employee-type relationships (e.g. directors, contractors). Employees are assessed under the ESS rules, even where ESS interests are provided to their associates (e.g. their spouse or family trust). The associate is subsequently taxed on disposal under CGT or ordinary income rules.
- Employers who issue ESS interests now have annual ATO reporting obligations.
- The new rules provide 'look through' treatment for Employee Share Trusts, however such trusts must meet specific requirements to be eligible.

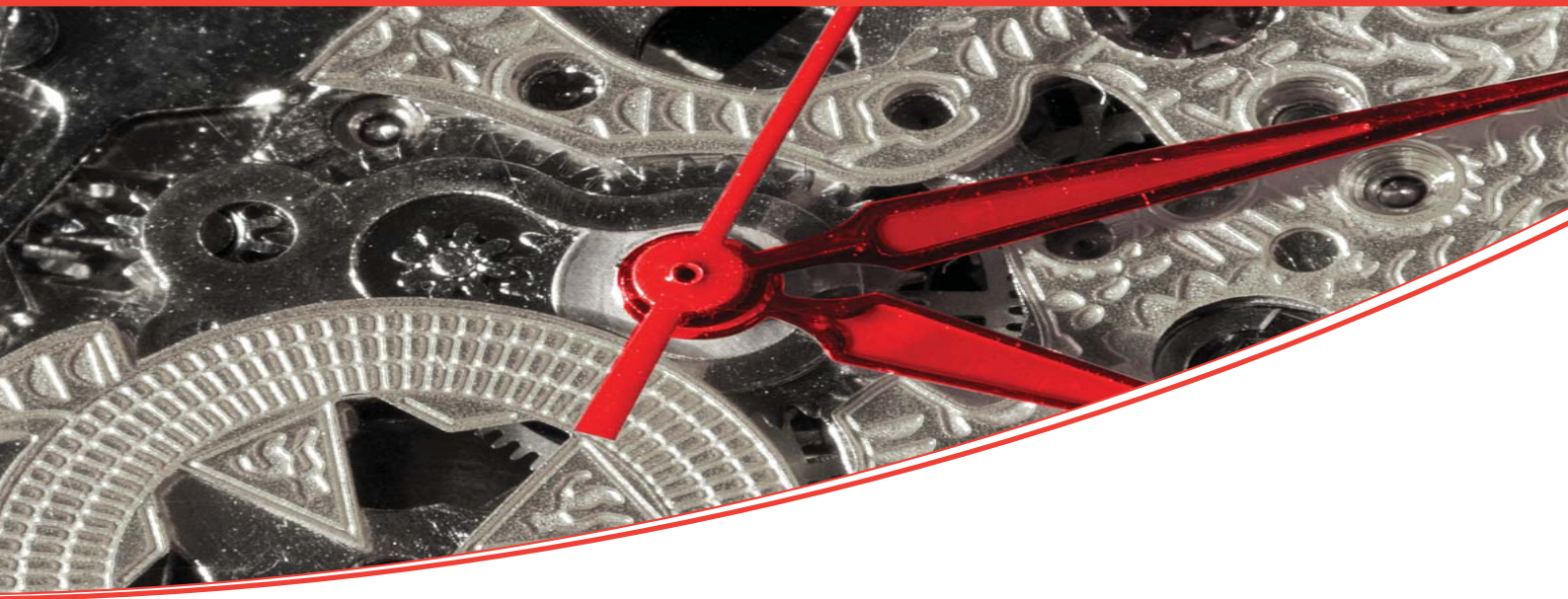
Plans, Tips and Traps

In assisting employers with implementing plans under the new rules, we have encountered a number of trips and traps, which are summarised below:

- For unlisted rights or options, fluctuations in share prices may mean that employees are taxed under the ESS rules (either upfront or deferred) without ever actually being 'in-the-money'. Where these options lapse at the election of the employee, there is no ability to obtain a refund of tax paid;
- Shares or options subject to deferred taxation may find the market value of the interest rises substantially between the date of grant and the deferred taxing point. This increase will be assessable under the ESS rules without any CGT relief.

- Using performance rights/shares with meaningful hurdles may be a better alternative to issuing options subject to deferred taxation. If performance hurdles are met, the employee receives some value under the scheme even if the share price drops between grant and the deferred taxing point. They also allow the employee to sell shares to fund their tax liability.
- Loan schemes where employees are provided with an interest-free loan to acquire shares at market value are not taxed under the ESS rules, as there is no discount received. The employer may be liable for FBT on the loan, unless the loan satisfies the 'otherwise deductible rule'.
- Certain schemes may entitle employees to receive a \$1,000 reduction in their assessable discount, if their income is less than \$180,000 and the scheme meets certain conditions. Employers are also entitled to claim a tax deduction for \$1,000 per employee under such schemes.
- Salary sacrifice schemes are eligible for deferred taxation even if no real risk of forfeiture, however such schemes must meet certain conditions and are subject to a \$5,000 cap per employee.
- Employers must consider whether GST can be claimed on costs of implementing an ESS, as issuing shares is a financial supply. GST may be claimed on costs where the 'Financial Acquisitions Threshold' is met and we note the ATO has undertaken a number of reviews in this area recently.
- Shares and options issued to employees are 'taxable wages' for payroll tax purposes.
- Companies should also consider ASIC and ASX requirements and reporting entities need to consider Accounting Standards for share based payments and executive remuneration.





How RSM Bird Cameron can help

- RSM Bird Cameron has been actively involved in assisting clients with their ESS. We can provide:
- Specialist Taxation advice on structuring the plan together with setting out the consequences for employee and employer.

- Our Corporate Finance Division can assist in providing market valuations of rights and shares.
- Our Audit Division can assist with corporate governance and accounting standard requirements.

Please note that this information does not constitute advice and should not be relied on.

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