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Article Information

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Resurrecting Employee Share Schemes

How will the evolution of Employee Share Schemes and the forecast changes to the tax treatment of these Schemes affect public and private companies?

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INTRODUCTION

The 2014-2015 Australian Commonwealth Budget in its Economic Outlook gave this snapshot of the economic circumstances influencing the Budget measures:

"The Government has been left with an economy growing below trend for four of the past five years and rising unemployment. A transition period continues with the mining construction boom now ending, the population ageing and low productivity growth.
For the economy to once again reach its full potential, we need to increase activity in the non-resources sectors, fostering a work culture and boost productivity growth."

Against this background, on 14 October 2014, the government released its Industry Innovation and Competitiveness Agenda, announcing in general terms the changes foreshadowed to the tax treatment of Employee Share Schemes (ESS). An exposure draft of the legislation was released on 14 January 2015. The changes will affect public and private companies which issue equity, or options to acquire equity, (broadly, "interests") to employees or directors at a discount to market value as a means of remuneration, incentivisation, retention or raising capital. Treasury consultation is ongoing, with the changes expected to apply to interests acquired after 30 June 2015.

The stated purpose of the changes is to support entrepreneurship, particularly start-ups, as a means of fostering job creation and productivity growth. The proposed changes are a direct response to the adverse consequences that have followed amendments made in 2009 to the tax treatment of ESS. The 2009 amendments created a tax liability for employees receiving the interests, before they were able to sell the shares and access cash proceeds. Although the 2009 amendments were intended to counter perceived abuses by corporate executives in mature businesses earning more than $180,000 per year, they had the effect (amongst others) of stifling the establishment and growth of start-up businesses, which have traditionally been heavily reliant on the ability to use shares and options as a means of attracting talent and investors and remunerating founders and key employees. Start-ups in the technology and biotech fields were particularly hard hit. The result has been a depression of activity in the start-up sector and movement of enterprises and talent offshore, to the detriment of the Australian economy. The government has recognised the importance of reforming the tax treatment of ESS in regenerating an environment capable of promoting and sustaining innovation, international competitiveness and growing productivity.

It is timely during the current consultation period, and pending the anticipated delivery in 2015 of the government's White Paper on the Reform of Australia's tax system, to examine the proposed changes to better inform the consultation process and shape the final form of the legislative measures. This paper does so by considering the proposed changes in the context of the evolution of the tax treatment of ESS in Australia since 1995, to the extent that is relevant to the proposed changes, rather than only by comparison with the current provisions. Even a broad canvassing of the development, without reviewing the provisions prior to 1995 in any detail and without reference to the particular economic drivers in play at each stage, provides useful insights.

The result is a high-level perspective on:

- the rationale behind the 2009 changes and the reason they had the impact they did
- the deficiencies in the proposed changes, if they are to achieve their stated purpose
- additional measures and alternative measures that should be considered
- the role that an anti-avoidance mentality has played in shaping federal tax policy in this area and an argument against continuing to allow that mentality to have such prominence.

Outline of the changes

Concessions for start-ups

It is proposed that upfront taxation will be removed on options and shares which are issued at a small discount (15% or less) by eligible start-up companies, provided they are held by the employee for more than three years. The tax deferral period will be extended from the current seven years to 15 years. Eligible start-up companies will be defined as unlisted private or public companies with a turnover under $50m that are less than 10 years old.

Concessions for all companies

Options issued by all companies will no longer be taxed in the year in which they are issued and will instead be taxed in the year in which they are exercised. This will effectively reverse one of the main detrimental impacts of the current provisions and return companies to the position that existed between 1995 and 2009.

Tax on the discounted price of shares will be deferred until the shares are sold, so that the employee is taxed on the capital growth in the value of the shares when that growth is realised – a position that is more aligned with the treatment in the US and UK.

It is proposed to retain the current $1000 upfront tax concession for employees who earn less than $180,000 per year, the current threshold for the top marginal rate of personal income tax.

<u>EVOLUTION OF ESS TAX TREATMENT</u>

1974 – 1995: Section 26AAC regime

Section 26AAC was inserted into the *Income Tax Assessment Act 1936* (Cth) in 1974 to provide for the taxation of benefits that arose from shares, or rights to acquire shares, acquired under an employee share scheme where the acquisition was connected with services rendered by a person as an employee or in a similar capacity. It replaced subs 26(e) ITAA36, which had dealt only in general terms with “benefits” provided to employees, as the basis for taxing benefits acquired under an ESS. Subsection 26(e) continued to operate in respect of other benefits received by employees until its repeal (as inoperative) in 2006. Section 26AAC was repealed in 2009 and replaced by Division 83A of the *Income Tax Assessment Act 1997* (Cth).

Overview of Section 26AAC

Subsection 26(e) had had the effect of measuring the value of the benefit received from an acquisition of interests in the year of acquisition and included any value as assessable income of that year.

Section 26AAC operated to include a benefit received under an ESS in the recipient’s assessable income in the income year in which the shares were acquired. Unless a right was sold, there was no longer any liability to tax until a share was acquired. The value of the share on the date of acquisition, less any costs of acquiring it, was included in assessable income. Profit on sales of rights was also assessable in certain circumstances. The provisions covered employees, their associates, contractors, consultants and, from 1988, directors.

Concessions

Following the introduction of capital gains tax in 1985 and fringe benefits tax in 1986, two alternative concessions were available: deferral of tax or an exemption of up to $200. However, access to the concessions was limited to taxpayers who were employees or directors of the employer company.

Shares which were subject to restrictions or conditions such that the holder did not have an unfettered right to sell the share, or was liable to be divested of ownership of it, were deemed to be acquired when the restrictions or conditions ceased to have effect. Following the introduction of capital gains tax, the holder of the shares acquired after 19 September 1985 was able to elect to be assessed in the year in which such shares were actually acquired, rather than the year in which they were deemed to be acquired upon cessation of the restrictions or conditions (thereby enabling the employee to index the cost base of the shares over a longer period).

The ordinary taxing point for rights was when the rights were sold or exercised. From 1986, the holder of the rights was also able to elect to be assessed in the year in which the right was acquired (issued or granted in relation to the holder's employment) and not in the year in which the right was disposed of by sale or by exercise.

Alternatively, an amount of up to $200 per year could be excluded from the assessable income of shares or rights, to a maximum of $2000 (a maximum discount of 10% on shares worth $2000). The employee was able to elect not to apply this concession and instead defer the tax liability.

However, in respect of shares and rights acquired after 19 September 1985, any amount excluded was effectively clawed back under the capital gains tax regime, which reduced the deemed market value cost base of the shares or rights by the amount excluded, thereby increasing the amount of capital gains tax payable on disposal of the shares or rights.

Further, the following conditions were introduced in 1988 in respect of the $200 exemption, which were to be met by the scheme at the time when the interest was acquired:

- All shares that could be acquired under the scheme, including upon exercise of a right, had to be ordinary shares.
- The scheme had to require that no interest could be disposed of (other than, in the case of a right, by exercise) within three years after acquisition, unless the employee ceased employment.
- The scheme had to be restricted to permanent employees only.
- The scheme and any related financial assistance had to be operated on a "non-discriminatory basis". The scheme had to be open to all permanent employees with at least 12 months' service. Information about the scheme had to be made available to all permanent employees. The time for acceptance of each offer had to be reasonable and the same for each employee. The consideration and the number of interests available had to be the same for each employee.

1995 – 2009: Division 13A regime
Taxation of the discount on interests acquired under an ESS after 28 March 1995 was governed by Division 13A of Part III, ITAA36. The relevant acquisition date for stapled securities was 1 July 2006.

These provisions were a response to the then government's view that ESS had been open to tax minimisation abuse by corporate executives of established companies. The explanatory memorandum to the Act which introduced Div 13A simply states:

"revenue savings are expected as the measures counter a number of arrangements which exploited the existing provisions in the income tax law".

Overview of Division 13A

The foundation principle of Div 13A was upfront taxation, that is, to bring to tax the discount given in relation to an interest acquired under an ESS in the income year in which the interest was acquired.

The discount was measured, in general terms, as the difference between the market value of the interest and any consideration given to acquire the interest.

If the interest was a "qualifying" interest, two concessions were available. Tax liability could be deferred for up to 10 years if the qualifying rights were subject to disposal restrictions. Alternatively, the recipient could elect to pay tax upfront on the amount of the discount, less a $1000 exemption, if certain requirements were met.

"Qualifying" interests

An interest was a "qualifying share" or "qualifying right" if the interest was an ordinary share, or a right to acquire an ordinary share, in the employer (or a holding company of the employer) acquired by the employee (or an associate) under an ESS and the following conditions were met:

- At the time of acquisition of the interest, at least 75% of the permanent employees of the employer were (or had previously been) entitled to acquire interests under the ESS or another ESS.
- Immediately after the acquisition of the interest, the recipient must not hold more than 5% of the shares in the company and must not control more than 5% of the voting power of the company.

Another of the stated purposes of these provisions was *"to ensure that the concessions available are 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 available to all permanent employees".*

The deferral concession

This was the default position in respect of qualifying interests. The discount was brought to tax in the income year when the "cessation time" occurred, unless the employee made an election to have the discount taxed up front.

In relation to qualifying shares, the cessation time in some circumstances was the time of acquisition (ie, there was no deferral). Those circumstances were where there were no disposal restrictions attached to the shares and no ESS condition that could lead to forfeiture of the share. Otherwise, the cessation time for a qualifying share was the earliest of the following times:

- disposal of the share
- expiration of the disposal restrictions and forfeiture conditions
- cessation of employment
- 10 years after acquisition.

In relation to qualifying rights, the cessation time was the earliest of the following times:

- disposal of the right other than by exercise
- exercise of the right if the shares acquired were not subject to any disposal restrictions or forfeiture conditions
- expiration of any disposal restrictions and forfeiture conditions attaching to the shares acquired upon exercise of the qualifying right
- cessation of employment
- 10 years after acquisition.

In relation to stapled securities, the cessation time was the time when a component of the stapled security became unstapled or when the stapled security ceased to be listed.

The $1000 exemption

The exemption requirements were these:

- The ESS did not impose any forfeiture conditions.
- The ESS must have imposed disposal restrictions requiring the interests to be held until the earlier of three years or cessation of employment.
- The ESS and any related financial assistance scheme had to have been operated on a non-discriminatory basis. Participation in the ESS must have been open, and the material terms of the ESS must have been the same, for at least 75% of all permanent employees of the employer, and the acceptance time must have been reasonable. Permanent employees expressly excluded (amongst others) employees who were directors of the company.

Calculating the discount

Where the discount was taxed up front, it was calculated as the difference between the "market value" of the interest when it was acquired and the amount of any consideration given by the recipient.
Where taxation of the discount was deferred, the discount was calculated as the difference between the consideration received for the disposal of the interests (including any shares acquired as a result of exercising any right) and any consideration given for the acquisition of the interests. Otherwise, the discount was calculated as the market value of the interests less the consideration given for their acquisition.

Amendments to Division 13A

In 1997, the $500 exemption was increased to $1000, so as to *"broaden access to, and increase the benefits of, participation in employee share schemes"*.
The thresholds for employee participation, for the purposes of the definitions of "qualifying rights" and "non-discriminatory basis", both relevant to eligibility to access the concessions, were also amended to reduce the threshold in each case from 75% to 2/3rds. These amendments were made by Act No 122 of 1997 to *"[make] it easier for an employee share scheme to qualify for concessional tax treatment under Division 13A"*. However, within a matter of months, both thresholds were increased to 75% without explanation.

Since 2009: the Division 83A regime

As a result of the 2009 amendments, the amount of the discount has become taxable in the year in which the shares or options are issued, unless the shares or options are at a "real risk of forfeiture" or are obtained under a salary sacrifice arrangement (and other requirements are met). Where the discount is assessable upfront, a $1000 exemption is available in limited circumstances. Where tax on the discount is able to be deferred, tax becomes payable at the earliest occurrence of a number of trigger events, but within seven years after issue. The amount of the discount is measured as the difference between the market value of the share or option, and its cost base, which is effectively what the recipient gives to acquire it. Market value takes its ordinary meaning in respect of shares and listed options, but the pre-2009 rules for determining the market value of unlisted options continue to apply.

Overview of Division 83A

The Division 83A regime replaced the Division 13A regime, with effect from 1 July 2009. The foundation principle remained the taxation of the discount on ESS interests and the scope of the regime continued to extend beyond employees and their associates to cover recipients of ESS interests whose relationship with the company was one of service, such as directors and other office holders and independent contractors. The scope was also extended to cover past "employees" (that is, including the broader class of recipients) and prospective "employees" of the company as well as any subsidiary of the company. Further, the scope was also extended to cover interests in corporate limited partnerships, corporate unit trusts and public trading trusts.

The most significant shift under the Division 83A regime was the return to the default position for upfront taxation of the discount on ESS interests. Deferred taxation was limited to circumstances where the interests were at a "real risk of forfeiture" or the interests were obtained under a salary sacrifice arrangement, subject to a number of other restrictions. Taxation of the discount under Div 83A upon receipt of an ESS interest may not be the only point at which liability arises; any subsequent capital gain or loss falls to be taxed in the same was as in respect of any other asset, that is, under the capital gains tax provisions or the trading stock provisions.

Deferral of upfront taxation

Two circumstances may give rise to the ability to defer payment of tax on the discount: real risk of forfeiture circumstances or salary sacrifice circumstances.

In the salary sacrifice circumstances, deferred taxation is available if the interests are shares, not rights, acquired under a salary sacrifice arrangement, the recipient receives no more than $5000 worth of shares under those arrangements in an income year and the ESS rules expressly state that deferred taxation applies to the scheme.

In the real risk of forfeiture circumstances, the interests acquired must relate only to ordinary shares and must be subject to a "real risk of forfeiture". Shares are at a real risk of forfeiture if a reasonable person would consider that there is a real risk under the conditions of the ESS that the recipient would forfeit or lose the shares other than by disposing of them. Rights are at a real risk of forfeiture if a reasonable person would consider that there is a real risk under the conditions of the ESS that the recipient would forfeit or lose the rights, other than by disposal, exercise, lapse or the value of the interest falling to nil. In addition, there is a real risk of forfeiture of rights if the conditions of the ESS provide for a minimum term of employment, staged vesting or "good leaver" provisions.

In relation to both shares and rights, additional conditions must be met before deferral is available:

- The recipient must be employed (in the broad sense mentioned above) by the company issuing the interests or its subsidiary.
- The ESS must be offered in a non-discriminatory way to at least 75% of Australian resident permanent employees of the company with not less than three years of service.
- The recipient must not receive more than 5% of the shares in the company and must not control more than 5% of the voting power of the company.

Where deferral is available, the taxing point in the case of shares is the earliest of:

- when there ceases to be a real risk that the recipient will forfeit or lose the shares (other than by disposal) and there are no genuine restrictions preventing disposal
- on cessation of the employment to which the interests relate
- seven years after acquisition.

In the case of rights, the taxing point is the earliest of:

- when there are no longer any genuine restrictions on the disposal of the right and no real risk of the recipient forfeiting the right
- when there are no longer any genuine restrictions on the exercise of the right or the disposal of the underlying shares and no real risk of the recipient forfeiting the right or underlying shares
- on cessation of the employment to which the interests relate
- seven years after acquisition.

The $1000 exemption

The amount of the discount subject to upfront taxation may be reduced by $1000 if the following conditions are met:

- The sum of the recipient's taxable income (including the full amount of the discount by disregarding the exemption), reportable FBT total, reportable superannuation contributions and total investment loss for the income year must not exceed $180,000
- The recipient must be "employed" (in the broader sense referred to above) by the company issuing the ESS interest, or its subsidiary.
- The ESS must only be offered in a non-discriminatory way to at least 75% of Australian resident employees with not less than three years of service.
- The interests must not be at real risk of forfeiture.
- The interests must relate only to ordinary shares.
- The interests must be held by the recipient for at least three years or until employment ceases.
- The recipient must not receive more than 5% of the shares in the company and must not control more than 5% of the voting power of the company.

Calculating the discount

The amount of the discount on ESS interests is brought to tax in respect of the income year in which the interests are acquired, unless deferred taxation is available. When taxed upfront, the discount is measured as the difference between the "market value" of the interest on acquisition and any consideration given by the recipient to acquire the interest. When the taxing point of the discount is deferred, the discount is measured as the difference between the market value of the interest at that time, and its cost base (which is generally calculated in the same way as for the purposes of the capital gains tax provisions).

Amendments to Division 83A

It is interesting to note that no amendments have been made to Div 83A since it came into operation in 2009. One explanation for this may be that, as the government has noted, these provisions effectively ended the use of ESS in Australia, so that the provisions are of no import in practical terms.

SUMMARY

Each of the regimes that has been in place since 1936 has had a number of provisions in common. In broad terms, each has brought to tax the value of a benefit received by taxpayers or their associates in relation to services provided by the taxpayer and has measured that benefit as the difference between its value and the consideration given for it. From 1995, "value" has meant "market value".

The key differences between all of the regimes over time are the taxing point and the availability of an exemption. The key differences between the ITAA36 regimes and the current regime are the taxing point, the availability of an exemption and the scope of the application of Div 83A.

Subsection 26(e)

The taxing point was the year of acquisition of the interests giving rise to the benefit.

No deferral of the liability was available.

No exemption of any part of the amount subject to tax was available.

Section 26AAC

The taxing point in relation to shares remained the year of acquisition, but in relation to rights, became the year of disposal, that is, the year in which the right was sold for a profit or the year in which a share was acquired upon exercise of the right.

From 1988, deferral of the liability was made available to recipients who were employees (engaged pursuant to a contract of service) or directors. Shares which were subject to disposal restrictions, or liable to forfeiture, were deemed to be acquired when the disposal restrictions or forfeiture conditions ceased to have effect.

An exemption was available as an alternative to deferral, provided that at the time the interests were issued, the scheme imposed a minimum three-year holding period and was open to all permanent employees with at least 12 months' service and was otherwise operated on a "non-discriminatory basis".

Division 13A

The taxing point in relation to shares remained the year of acquisition, but in relation to rights, returned to the pre-1995 taxing point of the year of acquisition. However, if the shares or rights were "qualifying shares" or "qualifying rights", the default position in fact became one of deferred taxation, unless the taxpayer elected to pay tax upfront to take advantage of the exemption.

Qualifying interests were those issued under an ESS that was open to at least 75% of permanent employees, where no recipient acquired more than 5% ownership or control in the company.

The exemption conditions continued the minimum three-year holding period. The requirement that the ESS did not impose any forfeiture conditions, which had previously been a condition for deferral, instead became a condition for the exemption.

The requirement that the ESS operate on a non-discriminatory basis also continued. Some changes were made, but two were particularly significant: the express denial of the exemption to directors and the introduction of a deferral period of up to 10 years.

Although the requirement that the scheme be open to permanent employees was reduced from a participation threshold of 100% to 75%, directors were excluded from being able to claim the exemption. This effectively meant that a director who received a qualifying share or a qualifying right had no incentive (in the form of an exemption) to elect to pay tax upfront. The impact of this measure was significantly increased by the simultaneous introduction of a deferral period of up to 10 years. As could be expected, directors who received ESS interests became incentivised to defer their liability. In practical terms, it was not difficult to do so in relation to rights as the circumstances which would trigger the taxing point sooner than 10 years were generally matters within the control, or at least the influence, of the director, namely, disposal or exercise of the right and cessation of employment. The result, in the writer's experience, was that it became common practice for directors' remuneration to include qualifying ESS rights issued at a discount, the liability for which could be deferred for up to 10 years.

Division 83A

The measures introduced in Div 83A can be seen, at least in part, as a response to the practice that developed in issuing qualifying rights to directors. The extent of the changes to the taxing point and the exemption, coupled with the extension of the applicability of the regime to past and prospective employees, subsidiaries of the employer, corporate limited partnerships, corporate unit trusts and public trading trusts, supports the view that these provisions were the product of a perception on the part of the government at the time that Div 13A ITAA36 was being used as a tax avoidance mechanism. In addition, there was a concern that some benefits received under ESS were not being disclosed or taxed. This concern was addressed by the imposition in Div 83A of annual ESS reporting obligations on employers. The obligations are an administrative burden for employers, but have removed the non-disclosure concern from the agenda without creating any other adverse impacts. The proposed changes will retain these measures.

The taxing point in relation to rights was returned to the pre-1995 default position of taxing the discount on ESS rights in the year of acquisition, apparently as a means of accelerating the time at which tax on the discount would become payable, particularly in respect of directors earning in excess of $180,000 per year.

Deferral of the liability in relation to discounts on rights is possible only if (amongst other conditions) the rights are at a real risk of forfeiture, the definition of which expressly excluded circumstances where the value of the right could fall to nil. The further conditions require that the recipient must be an employee (including a director) of the company issuing the rights, which appears to be another integrity measure designed to prevent the circumvention of the conditions. The further conditions also require that the ESS must be offered to at least 75% of permanent employees, with the additional requirements that these employees are residents of Australia for tax purposes and have been employed by the issuer for at least three years. The latter requirement had previously applied only to shares under Div 13A, and not to rights. The period of service in relation to rights under s 26AAC had been 12 months. The aggregate effect of these requirements is to limit the availability of the deferral concession generally, rather than only in respect of directors or employees whose income is in the top tax bracket.

Where deferral is available, it is limited in a number of ways, compared with Div 13A. First, the maximum deferral period of 10 years has been reduced to seven years. Second, two of the trigger events that had been within the control of directors (disposal or exercise of a right) have both been removed. Leaving aside resignation from employment, which remains as a trigger point, the taxing point now occurs (subject to the seven-year maximum period) in the year in which the rights cease to be subject to any restriction condition or liable to forfeiture, both of which circumstances are outside the control of directors.

The aggregate effect of these provisions has been to severely curtail the ability of directors to defer liability for tax on the discount of any rights issued under an ESS. Not only do these provisions effectively accelerate the time at which tax becomes payable, the directors (and other recipients of rights) must meet the liability before they have acquired any shares which could be sold to fund the payment. Nor has access to the exemption been made more available. New conditions were introduced in Div 83A which deny the exemption in respect of schemes that are not limited to permanent employees who are residents of Australia with a minimum of three years' service and in respect of rights and shares acquired by any recipient whose taxable income (defined widely) exceeds $180,000.

It is not difficult to understand how these measures had the detrimental effects that the current government now seeks to address.

PROPOSED CHANGES

All companies

An ESS will be able to be established as either a deferred tax scheme or an upfront tax scheme (as determined by the scheme's governing rules).

An employee who acquires interests under an upfront tax scheme will be eligible for the current $1000 exemption of the amount of the discount subject to tax, provided the employee's gross income for the income year in which the interests are received (as determined under the current rules) does not exceed $180,000.

The maximum ownership and voting restrictions will be eased from 5% to 10%.

The current tables in Division 13A ITAA36 used to value unlisted rights will be updated. The current ESS reporting requirements and TFN (ESS) withholding tax are to be retained.

Rights

An employee who acquires rights under a deferred tax scheme will be able to defer tax until the rights are exercised or the employee's employment ends, up to a maximum period of 15 years. On exercise, income tax will be payable on the difference between the market value of the right at that time and the amount paid to acquire it.

In addition, capital gains tax will be payable when the shares acquired by exercising the right are sold, on the difference between the sale price and the market value of the shares on the exercise date.

Shares

The tax treatment of the discount provided will depend on whether the shares are at a real risk of forfeiture.

If there is no real risk of forfeiture, income tax will be payable on the discount in the year the shares are received. The $1000 exemption may be available.

If there is a real risk of forfeiture, the liability to pay tax on the discount may be deferred until that risk ceases to exist. When that happens, income tax will be payable on the difference between the market value of the shares at that time and the amount paid to acquire the shares. The $1000 exemption will not be available.

In addition, capital gains tax will be payable when the shares are sold (or some other CGT event happens to them). The amount of the gain subject to tax will be the difference between the sale price of the shares and the market value of the shares when the risk of forfeiture ceases to exist.

Eligible start-up companies

A company will qualify as an "eligible start-up company" if the company is unlisted, has been incorporated for less than 10 years and has an aggregate turnover not exceeding $50m.

If the discount on interests issued by eligible start-up companies is "small", and the interests are subject to a minimum holding period of at least three years, the discount may be exempt from tax or the liability may be able to be deferred until the sale of the shares, or in the case of rights, the sale of the underlying shares (unless a non-sale CGT event occurs before sale). In relation to shares, the discount must not exceed 15% of the market value of the share when at the time of acquisition. In relation to rights, the exercise price must not be less than the market value of an ordinary share at the time the right is acquired.

The sale of shares will give rise to a taxable capital gain, measured as the difference between the sale price and the market value of the shares at the time of acquisition.

The sale of shares acquired upon exercise of a right will also give rise to a taxable capital gain, measured as the difference between the sale price and the price paid to acquire the shares (the exercise price). Rights themselves will also be subject to the capital gains tax regime.

Unresolved Issues

If the proposed measures are to succeed in resurrecting ESS, the benefits available to recipients of ESS interests will need to be more widely available and more attractive than at present under Div 83A. The proposed changes, at present, do not make the start-up concessions available to listed companies. This will exclude all start-ups companies which list within the first 10 years of establishment as a means of accessing capital through public offerings, rather through debt funding. The rationale for excluding such companies, which would otherwise qualify as start-up companies, is unclear. No similar limitation has been in place under Division 83A or any of the predecessor regimes. The proposed changes are also limited to employees with not less than three years' service. Again, if start-ups are to benefit from these changes as intended, this requirement should be shortened or removed.

One of the drivers behind the Div 83A provisions was to accelerate the time at which tax on discounted shares and rights becomes payable. If the new provisions are intended to achieve this, they must make the alternative of paying tax upfront more attractive. One way of doing so would be to increase the value of the $1000 exemption, which has not changed since 1997, and make the relief available to employees irrespective of their annual remuneration, as was the case until 2009. The proposed changes afford little, if any, incentive for any ESS to be established as an upfront scheme.

It should also be appreciated that rights acquired under deferred tax schemes by companies other than eligible start-up companies will be subject to income tax, and not to capital gains tax, on exercise. This means that in respect of such rights, neither the Division 115 ITAA97 CGT 50% general discount nor the Division 152 ITAA9715-year 100% exemption from capital gains tax would be available. The full amount of the increase in the capital value of the right since acquisition will be subject to income tax. Even if the discount on shares acquired under such schemes was taxed upfront because there was no real risk of forfeiture, the $1000 exemption may be available and it is the amount of the discount, not the full amount of any capital growth, that would be subject to tax. There is thus little incentive for anyone to accept rights as opposed to shares in such circumstances.

In the case of eligible start-up companies, an acquisition of rights is also much less attractive than an acquisition of shares. Deferral of tax on the discount in respect of rights is only available if the exercise price of the rights is at least equal to the market value of ordinary shares in the company at the time the rights are acquired. Shares in eligible start-ups issued at a discount to market value of up to 15% can be acquired without triggering any liability to upfront tax. The nominal concession in relation to rights is unlikely to attract many takers.

Further, the proposed changes will not remove or ease the Div 83A conditions which deny the exemption in respect of schemes that are not limited to permanent employees who are residents of Australia with a minimum of three years' service and in respect of rights and shares acquired by any recipient whose taxable income (defined widely) exceeds $180,000.

CONCLUSION

Division 83A caused the damage which the proposed changes now seek to remedy. The provisions in Div 83A were a direct response to the twin flaws in Div 13A, the denial of the exemption to directors coupled with the 10-year tax deferral period. But the approach taken in Div 83A was itself flawed in two main respects. First, it was based on a perception that ESS rights were being used to replace remuneration. This overlooked the reality that ESS interests have traditionally been issued as a supplement to cash remuneration, rather than as a replacement. It also overlooked the fact that revenue was not lost under the Division 13A provisions, rather, it was delayed. Further, it overlooked the fact that where ESS increase productivity, taxable wealth is generated. In addition, the approach taken in Div 83A was based on a perception that if access to the deferral concession was restricted, this would accelerate payment of tax. This was misconceived. Not only was payment of tax not accelerated, the use of ESS was largely abandoned, resulting in a loss of revenue from discounts on interests and, as has been seen, a loss of the revenue generated by the businesses which ultimately left Australia altogether.

It is unfortunate that the response to the unintended consequences of the operation of Div 13A was not addressed in a more measured and appropriately focused manner. For example, it would have been preferable to make the exemption available to directors and to reduce the 10-year deferral period. Alternatively, Div 83A could have enacted provisions dealing only with the taxation of benefits received by high income earners, or benefits in excess of a threshold amount per annum, without inadvertently penalising ESS issuers and recipients who were not abusing the concessions and without prejudicing the existence of a critical sector of the economy.

It is also unfortunate that the proposed changes do not appear to go far enough to generate much expectation of resurrecting ESS in respect of rights. It is clear, and the government recognises, that one of the main reasons why ESS in Australia ceased to operate in any economically meaningful way was the adverse tax consequences of acquiring rights, namely, that tax on the discount was payable upfront. The proposed changes will remove that one disadvantage by permitting deferral to some extent, but the proposed tax treatment overall of acquiring ESS rights is not attractive and compared with acquiring ESS shares is even less attractive.

It is to be hoped that in the final formulation of these changes to Div 83A, a better balance can be struck between achieving the stated economic outcomes and managing what is genuine anti-avoidance behaviour.

Finally, it is to be hoped that the White Paper to be released in 2015 into reform of Australia's tax system contains additional measures to encourage employee share ownership.

For further information on this and other taxation law issues, please contact Partner, Judy Choate.