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ESOP Tax changes announced

On 14 October, the Federal Government announced the changes it foreshadowed to the tax treatment of Employee Share and Option Plans (ESOPs)

The changes are significant for any company, whether public or private, which would benefit from issuing equity (or options to acquire equity) to employees or directors at a discount to market value as a means of remuneration, incentivisation, retention or raising capital.

Summary of the changes

- ***Concessions for eligible start-up businesses***
  Eligible start-up businesses will be unlisted private or public companies with a turnover under $50m that are less than 10 years old. Upfront taxation will be removed on options and shares which are issued to employees at a small discount by eligible start-up businesses, provided they are held by the employee for more than 3 years. The tax deferral period will be extended from the current 7 years up to 15 years.
- ***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, which have been in place since 2009, and return companies to the position that existed before 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.

Impetus for the changes

The changes announced are a direct response to the adverse consequences that have followed amendments to the tax treatment of ESOPs made in 2009. Although the 2009 amendments were intended to counter perceived abuses by corporate executives in mature businesses earning more than $180,000 per annum, 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 luring talent and investors and remunerating founders and key employees. Start-ups in the technology and biotech fields were particularly hard hit. The rules created a tax liability for the employees receiving the shares or options, before they were able to sell the shares and access cash proceeds.

Prior to the 2009 amendments, it was possible for recipients of shares and options issued at a discount to market value to elect to have the discount taxed in the year of issue and receive a $1000 tax exemption, or to defer the tax payable, in some cases for up to 10 years. These provisions had been in place since 1995 and were themselves a response to the government's view that ESOPs had been open to tax minimisation abuse by corporate executives of established companies.

As a result of the 2009 amendments, the amount of the discount became taxable in the year in which the shares or options were 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 7 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 pays 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.