The Tax Summit

Session 17.1: Employee equity incentive arrangements - Getting them right

Presented at International Convention Centre Sydney (ICC) 11–13 September 2024

Matthew McKee, FTI
Brown Wright Stein Lawyers

Contents

1. Overview

This genesis of this paper is that the writer is often asked to provide advice on the tax implications of employee equity incentive arrangements to advisers who were not involved in the design of the scheme. These advisers may be the tax agent/accountant for the employee or they may be the tax agent/accountant for the employer but who were not involved in the employee share scheme interest being issued to the employee(s).

Advising in such circumstances can be difficult, particularly as such advisers may not have complete information and may face time pressures.

This paper covers the following:

1. some recent horror stories for employee incentive arrangements;
2. some common models used and the tax treatment of such model;
3. advising employees on the arrangement;
4. the employer reporting obligations;
5. getting the payroll tax right; and
6. commercial and other legal considerations.

It should be noted that employee share schemes interests can come in many forms, including:

1. a thoroughly designed scheme in which the employee's tax implications have been considered by the employer's tax advisers;
2. a scheme in which plan rules (for a thoroughly designed scheme) have been copied without an understanding of the tax implications;
3. an agreement to transfer shares from an existing shareholder to an employee, with or without immediate regard to tax implications; and
4. an ad hoc agreement to issue shares to an employee, with or without immediate regard to tax implications.

This paper is not intended to be a comprehensive overview of the employee share scheme rules or to provide a comprehensive summary of the design features of employee inventive arrangements. If such a paper is sought, there are a number of excellent recent papers available from The Tax Institute's Resources section on its website.

In this paper, shorthand references to legislation the *Income Tax Assessment Act 1997* (Cth) and the *Income Tax Assessment Act 1936* (Cth) are referred to as the ITAA 1997 and ITAA 1936 respectively.

All examples in this paper have been developed for training to illustrate the employee share scheme rules and are not real cases. Any similarity to actual cases is purely coincidental.

2. The 'horror' stories

The stories below are not truly 'horror' stories but they do demonstrate that employee share scheme regime can have unexpected (although perhaps intended) outcomes for taxpayers. The stories demonstrate, to some extent, that the tax effectiveness of granting employee share scheme interests is not simply about how the "scheme" is designed but also how it is executed, including at the time of grant, what happens on vesting and what happens on exercise. This problem has somewhat been alleviated by the removal of termination of employment as a deferred taxing point (which meant the taxing point was not necessarily aligned to when the taxpayer could dispose of the shares), but it still persists.

What these 'horror' stories should indicate is that, outside of circumstances where the start-up concessions may apply, there is no perfect scheme design. Whether an employee would rationally want an employee share scheme interest taxed upfront or on a deferred basis often cannot be predicted at the time the shares are to be issued. Usually, employees do not have any input into the scheme design but, even when they do, whether they get the pick right (up-front versus deferred) will depend upon the subsequent financial performance of the company. If it is not clear, this means that the tax efficiency of an employee share scheme will not be determined by tax alone but financial performance. This means that full and complete advice for an employee on an employee share scheme would include advice not just from a tax advisor but also from a financial advisor.

2.1 Shares are now worthless but there is assessable income

A common problem with ESSs is that, by the time the shares are sold or realised, they may no longer be worth what they were at the time that they were assessable to the taxpayer. To some degree, the ESS rules in Division 83A of the ITAA 1997 seek to overcome this by aligning the taxing point with the time that the shares are at least capable of being realised so that at least the decision to not convert to cash is one made by the employee (i.e. it is a financial decision) and not due to the design features of the scheme. However, awareness of this problem is the key.

2.1.1 Fox[1]

In *Fox*, the taxpayer, Alicia, agreed to accept 700,000 Performance Rights in her employer, NewSat Limited, in October 2011 and June 2012.[2] The Performance Rights were convertible into shares on a one-to-one basis subject to certain vesting conditions.[3] Alicia was an Executive Assistant to the CEO of NewSat.[4]

350,000 of the Performance Rights vested in June 2014 at which time Alicia converted them to shares.[5]

In the second half of 2014, NewSat made a loss and was left with significant outstanding loan repayments to US and French financiers.[6] By April 2015, NewSat was in financial trouble and was placed into administration.[7]

[1] *Fox and Commissioner of Taxation* [2018] AATA 2791.
[2] Ibid at [14].
[3] Ibid at [13].
[4] Ibid at [3].
[5] Ibid at [19].
[6] Ibid at [7].
[7] Ibid at [8].

In May 2015, Alicia lodged her income tax return for the income year ended 30 June 2014 which included $106,058 in assessable income relating to the employee share scheme, being the difference between the amount she paid ($0) and the market value of the performance rights at the time of conversion.[8]

Not long after this, the administrators made various employees of NewSat, including Alicia, redundant.[9]

NewSat was subsequently placed into liquidation and in October 2015, the liquidators made a declaration that there was no reasonable likelihood that the shareholders of NewSat would receive any distribution in the course of the winding up.[10] At this point, Alicia's shares in NewSat were effectively worthless.

Alicia amended her tax assessment to exclude the amount included for her performance rights.[11] The Commissioner subsequently re-amended Alicia's assessment to re-include the amount for her performance rights.[12]

Alicia objected to the amended assessment and, when her objection was disallowed, applied to the Administrative Appeals Tribunal.

Alicia sought to argue that she had been pressured to accept the performance rights such that the issue of them to her was void at law.[13] Alicia lost in the AAT and the assessments stood.

The effect was that Alicia was subject to tax on the $106,058 but ultimately never received money of that amount.

COMMENT – the outcome for Alica was, undoubtedly, affected by her decision to not sell her shares immediately upon conversion of her Performance Rights. The difficulty is that advice on these matters is often not sought until later and by then, as was the case for Alicia, it may be too late.

2.1.2 COVID times example

Over the period of the COVID-19 pandemic, there was significant volatility in the price for certain company shares, including both listed and unlisted companies. This resulted in some adverse outcome for taxpayers under the employee share schemes.

Here is an example of this.

Bob was issued options to acquire shares and rights in a listed technology company that were not subject to the start-up concessions. The options were issued on terms that, upon vesting, the options remained incapable of being assigned but once the options were assigned, the shares could be transferred at any time. By contrast, the rights were able to be assigned prior to being exercised. The effect of this for Bob was that the "options" had a taxing point of vesting while the rights had a taxing point of the exercise of the options.

The distinction between the two types of ESS interests was not understood by Bob and, based on the ESS statements he had received for prior years, Bob had thought that all of his ESS interests had a taxing point of vesting.

Bob had options that had a taxing point in the income year ended 30 June 2020, as they had vested in that year, and rights that had a taxing point in the income year ended 30 June 2021, as he exercised them in that year. Bob had exercised these rights to commence the period that he owned the relevant shares for the

---

[8] Ibid at [85].
[9] Ibid at [9].
[10] Ibid at [89].
[11] Ibid at [90].
[12] Ibid at [91].
[13] Ibid at [111].

purpose of the CGT discount as Bob was concerned that he had unrealised capital gain in the shares given his understanding that the taxing point was vesting. The value of the shares at the time of exercise was $1,500,000. Twelve months later, the value of the shares was $550,000. The tax on the 'discount' at the time of exercise was greater than the now value of the shares.

2.2 Time of acquisition of ESS interest

2.2.1 Mangat[14]

In *Mangat*, in 2011, Dr Mangat, a medical doctor, was approached by IVF Australia Pty Ltd (**IVFA**), which was part of the Virtus Health group (**VH**) to be engaged as an independent contractor for a 5-year term.[15]

In November 2011, Mr Moller, the Managing Director of IVFA, informed Dr Mangat in a meeting that IVFA would offer equity incentives to specialists who agreed to a 5 year non-compete term.[16] Dr Mangat claimed to have been provided a VH Health Share Offer Information Statement (**2011 Share Offer**) during this meeting in November 2011, however, the 2011 Share Offer was dated 16 December 2011.[17] The 2011 Share Offer was for 150,000 shares in VH at $4.71 per share.[18]

In November 2011, Dr Mangat received an engagement letter from IVFA. The 2011 Engagement Letter was silent as to any offer of shares to Dr Mangat, rather, it provided that Dr Mangat *may* be offered shares during the term of the engagement.[19] Dr Mangat claimed the 2011 Share Offer was attached as 'Schedule A' to the 2011 Engagement Letter.[20] The 2011 Engagement Letter did not refer to an Annexure A, and in fact only referred to 2 enclosures, being a 'Fees and Services Schedule' and a 'Code of Conduct'.[21]

Dr Illingworth, who was involved in the negotiations with Dr Mangat on behalf of IVFA, testified that it was agreed in November 2011 that VH would offer Dr Mangat 150,000 shares as consideration for her agreeing to the 5 year non-compete clause.[22]

Ms Channon, the CEO of VH, also testified that she believed that on 16 December 2011, VH made an offer to Dr Mangat for 150,000 shares at an offer price of $4.71 per share, though this was subject to Dr Mangat meeting certain performance conditions.[23] Dr Mangat's assertion was that the offer was not subject to performance conditions.[24]

In 2011 VH was in the process of generally offering shares to new doctors. However, the 2011 Share Offer was not accepted by the ASX and had to be withdrawn and replaced by a subsequent share offer, being the 2012 Share Offer discussed below.[25]

On 23 January 2012, Dr Mangat commenced work with IVFA for a 1-year period, pursuant to an employment agreement signed on 2 February 2012 (**2012 Employment Agreement**), which was separate to the 2011

[14] *Mangat v Commissioner of Taxation* [2018] AATA 3012.
[15] Ibid at [9].
[16] Ibid at [11].
[17] Ibid.
[18] Ibid at [14].
[19] Ibid at [13].
[20] Ibid at [14].
[21] Ibid.
[22] Ibid at [39].
[23] Ibid at [42].
[24] Ibid.
[25] Ibid at [44].

Engagement Letter.[26] The 2012 Employment Agreement provided that Dr Mangat was entitled to wages of $117,810 plus super for the period, but was silent as to any offer of shares by VH.[27]

In January and February 2012, around the time Dr Mangat commenced work for IVFA, Mr Moller forwarded Dr Mangat an updated VH Share Offer Information Statement (**2012 Share Offer**).[28] The email provided that to participate in the employee share scheme, Dr Mangat had to 'sign the Share Purchase Application form on page 24 of the Offer Information Statement and return to Glenn Powers…. by 31 January 2012'.[29]

On 1 May 2012, Dr Quinn, a board representative of IVFA, emailed a group of 10 doctors, including Dr Mangat about a potential sale of VH and referred to the recipients as *' option holder[s]'* (**Doctor Group Email**).[30] On 17 May 2012, Dr Quinn emailed a larger group of people, including Dr Mangat, that they anticipated concluding the sale of VH between June and September 2012.[31] This email noted that the share options would vest on the sale event.

During this time, VH was receiving advice from PWC to ensure that sophisticated investors and unsophisticated investors received identical benefits under the employee share scheme. On 17 May 2012, PWC wrote to the board members of an investor in VH, to outline the income tax consequences of the proposed sale and noted that:[32]

> 'there are 26 New Doctors. The New Doctors do not currently hold any options, shares or rights…. 8 of these 26 New Doctors are Non-Sophisticated Investors… Virtus is unable to issue shares to Non-Sophisticated Investors under the method proposed in the Offer Information Statement. New Doctors who are Non-Sophisticated Investors will instead receive a cash bonus and options in the purchaser such that they should be in the same economic position as New Doctors who are Sophisticated Investors'.

Dr Mangat claimed that she was not a 'new doctor' at that time. However, Mr Powers, the Chief Financial Officer of VH, subsequently emailed Dr Mangat with the subject heading 'Virtus Health Liquidity Event – Binding Share Sale – Incentives for New Doctors', noting *'[f]urther to the letter you received on 18 May regarding the incentive arrangements for the new Doctors we wish to advise you…'*.[33] On 8 August 2012, Dr Mangat received a letter and a Share Offer form with the same subject heading, noting that VH's offer for *'recently contracted Doctors'* would not disadvantage unsophisticated investors.[34]

On 17 August 2012, Dr Mangat returned the signed Share Purchase Application form for the purchase of 150,000 options in VH.[35] The form tendered into evidence was the 2011 Share Offer form dated 17 August 2012, despite the 2011 Share Offer form stipulating that it must be returned no later than 31 January 2012. No other share offer form was put into evidence.[36]

The proposed sale of VH did not occur. In January 2013, a decision was made to undertake an IPO of VH.[37] In March 2013, Dr Mangat received an email from VH notifying her that a shareholder resolution had been passed to list VH on the ASX.[38] This was accompanied by an 'IPO Summary' document which provided that Dr Mangat could elect to receive an 'option offer' for 150,000 shares in VH in the income year ended 30 June 2013 at an

[26] Ibid at [18].
[27] Ibid at [19].
[28] Ibid at [20] and [21].
[29] Ibid.
[30] Ibid at [25].
[31] Ibid at [27].
[32] Ibid at [28].
[33] Ibid at [30]
[34] Ibid at [31].
[35] Ibid at [33].
[36] Ibid.
[37] Ibid at [35].
[38] Ibid at [36].

exercise price of $4.71, or cancel her share options and receive cash consideration of $271,500 and 39,206.[39] Dr Mangat elected to cancel her options, receiving $271,500 and 39,206 shares in VH.[40]

On 11 August 2015, the Commissioner sent a default assessment warning letter to Dr Mangat, noting she had failed to lodge her tax return for the income year ended 30 June 2013.[41] The Commissioner ultimately issued Dr Mangat a default assessment of $217,511.60.

Dr Mangat objected against the assessment and the penalty, on the basis that she had received the right to acquire options in VH upon signing the 2011 Engagement Letter and, therefore, was entitled to the 50% general CGT discount.[42] The Commissioner Dr Mangat's objection.[43]

Dr Mangat appealed the Commissioner's decision to the Administrative Appeals Tribunal.

Dr Mangat argued that it was clear from her subsequent conduct and actions that Dr Mangat intended in December 2011 to enter into binding relations premised on a right to receive 150,000 shares, which subsequently changed to options because she did not qualify as a sophisticated investor.[44] That is, Dr Mangat acquired a beneficial interest in the shares, or options, at that time. Dr Mangat contended that the issue of shares was not discretionary or dependent on her making an application.[45] The completion and return of the application form on 17 August 2012 merely formalised the transaction.[46]

The AAT considered the case law in relation to the timing of granting of options including:

1. *Federal Commissioner of Taxation v McWilliam* [2012] FCAFC 105 where the Full Federal Court found an employee under an employee share scheme acquires a ‘right’ within the meaning of former Division 13A of the ITAA 1936 upon acquiring a right to require the employer to issue options to purchase shares, and does not acquire that right only upon the issue of the options themselves;[47]

2. *Fowler v Federal Commissioner of Taxation* [2013] FCAFC 69 Mr Fowler had acquired a conditional right to insist that the company put the issue of options to him to the shareholders for approval. The Full Federal Court held that a conditional right to acquire options is not properly characterised as a right to acquire shares in the company for the purposes of former Division 13A of the ITAA 1936;[48] and

3. *Davies v Deputy Commissioner of Taxation* [2015] FCA 773 in which Perram J considered when certain shares and options were brought to tax in circumstances where the taxpayer acquired the right to have shares and options issued to him on a date under the terms of a deed entitled ‘Share Subscription and Offer Deed’, but subject to shareholder approval being obtained in respect of the shares and, in the case of the options, their exercise. His Honour held that the obligation to issue shares and options, although contingent, came into existence on the execution of the deed.[49]

The AAT concluded that VH had not made an offer of 150,000 shares at a price of $4.71 per share when the 2011 Engagement Letter was executed on 30 December 2011 and, therefore, an ESS interest had not been

[39] Ibid at [47].
[40] Ibid at [37].
[41] Ibid at [46].
[42] Ibid at [56].
[43] Ibid at [80].
[44] Ibid.
[45] Ibid at [82].
[46] Ibid.
[47] Ibid at [87].
[48] Ibid at [88].
[49] Ibid at [89].

issued to Dr Mangat at that time.[50] Accordingly, Dr Mangat was not eligible for the 50% general CGT discount.[51]

In coming to this conclusion, the AAT considered the contemporaneous documents to be the most reliable sources of evidence, given the discrepancies.[52] It was noted that the 2011 Engagement Letter did not reference terms of any equity incentive and was not satisfied that 'Schedule A' was part of the Engagement Letter, or that it was executed at the same time.[53] The email exchange between Dr Mangat and Mr Moller in January and February 2012 further contradicted Dr Mangat's contention that she had already been offered the shares and suggested Dr Mangat was a *'new Doctor'*, notwithstanding the fact that she was a recipient of the Doctor Group email.[54]

2.2.2 Informal agreement to transfer shares

Here is an example of this.

A company was incorporated. A trust and persons associated with the trust held more than 10% of the shares in the company.

A different person associated with the same trust was considering becoming an employee of a subsidiary of the company. In consideration of this, the major shareholder agreed to perform a share true up by transferring shares to the trust for nominal consideration. A short letter summarising the agreement to transfer the shares was prepared without the assistance of tax advisors or lawyers. It contained some conditions for the shares to be transferred.

The shareholding true up subsequently did not occur until many years later. At the time of the transfer, the value of the shares was substantially higher than the value at the time that the agreement was entered into.

The agreement to transfer the shares clearly gave rise to an ESS interest, as the transfer was being made as consideration for the employment of a prospective employee.[55]

The informal nature of the arrangement meant that it was not identified as an employee share scheme. It also gave rise to other issues to consider, including the following:

1. at what point in time was the ESS interest "provided to" the trust for the purpose of Division 83A, at the time the agreement was entered into, when the conditions were satisfied or when the shares were transferred. In other words, did the trust receive an indeterminate right for the purpose of Division 83A at the time that the agreement was entered into;
2. whether the ESS interest was taxed up-front or was subject to deferred taxation; and
3. whether the transferor and transferee were dealing at arm's length;
4. if the transferor and transferee were not dealing at arm's length, what was the time at which the market value substitution rule applied for the purposes of CGT A1 that happened to the transferor.

[50] Ibid at [63].
[51] Ibid at [60].
[52] Ibid at [61].
[53] Ibid at [61].
[54] Ibid at [68].
[55] *Income Tax Assessment Act 1997* (Cth), s 83A-10(2).

2.3 ESS interest increases in value from grant to taxing point

2.3.1 Gennai[56]

In October 2013, Gabriel Gennai entered an employment contract with his employer, Cloudera (Aust) Pty Ltd.[57]

The employment contract also mentioned that a recommendation would be made to Cloudera Inc's Board of Directors that Gabriel would be granted an option to purchase 60,000 Cloudera shares, subject to the terms and conditions of the Cloudera, Inc 2008 Equity Incentive Plan which would be amended to comply with Australian law.[58]

On 10 December 2013, Gabriel signed a document entitled 'Cloudera, Inc. 2008 Equity Incentive Plan Stock Option Grant Notice', under which Cloudera granted Gabriel a non-qualified stock option to purchase 60,000 shares in Cloudera, Inc., a Delaware company, at the exercise price of $3.64 per share.[59] The Grant Date in the Grant Notice was 8 November 2013, the Vesting Commencement Date was 14 October 2013, and the option expiry date was 7 November 2023.[60]

The Grant Notice contained a vesting and exercisability schedule, which provided:[61]

> One-fourth (1/4th) of the total number of shares subject to the Option shall vest and become exercisable on the one year anniversary of the Vesting Commencement Date, and 1/4th of the total number of shares subject to the Option shall vest on each subsequent one year anniversary of the Vesting Commencement Date thereafter, for a total vesting period of four years.

On 16 October 2014, Gabriel's employment was terminated. He was provided with an employment termination report and an Option Exercise Notice.[62] The termination report provided that:[63]

1. Gabriel had been granted 60,000 shares (sic) on 8 November 2013;

1. the exercise price per share was USD $3.64;

2. only 15,000 of Gabriel's shares have vested and were exercisable;

3. the total price to exercise the 15,000 shares was USD $54,600 (being 15,000 multiplied by USD $3.64); and

4. the last day to exercise the option was 16 January 2015.

On or before 31 December 2014, Gabriel paid the exercise price of $54,600 and on 1 January 2015, he executed an Exercise Notice and Stock Purchase Agreement.[64]

On 9 January 2015, Gabriel became the holder of 15,000 shares of Cloudera Inc.[65]

[56] *Gennai and Commissioner of Taxation* (Taxation) [2020] AATA 4667.
[57] Ibid at [3].
[58] Ibid.
[59] Ibid at [11].
[60] Ibid at [12].
[61] Ibid at [13].
[62] Ibid at [14].
[63] Ibid.
[64] Ibid at [16].
[65] Ibid at [18].

On 14 July 2015, Cloudera issued an Employee Share Scheme Statement to Gabriel for the year ending 30 June 2015.[66] The statement listed in, the line-item for 'discount from deferral schemes', an amount of $184,794.[67]

On 4 January 2017, the ATO sent a 'tax return lodgment' letter to Gabriel stating Gabriel may need to lodge a tax return for the financial year ended 30 June 2015 to include an amount for an ESS discount from deferral schemes of $184,794. [68]

On 15 February 2017, Gabriel lodged his tax return for the income year ended 30 June 2015 and did not account include any ESS discount for the shares in Cloudera, Inc.[69]

On 22 February 2017, the ATO issued a Notice of Assessment for the year ended 30 June 2015 on the information contained in Gabriel's income tax return for that year.[70]

On 23 March 2017, the ATO issued a Notice of Amended Assessment for the year ended 30 June 2015, increasing Gabriel's income by $184,794, representing the ESS discount for the shares in Cloudera, Inc.[71]

On 29 June 2017, Gabriel objected to the amended assessment and, after the Commissioner disallowed the objection, appealed against the objection decision to the AAT.[72]

In the AAT, Gabriel argued that he was subject to up-front taxation as there was not a real risk, under the conditions of the 2008 Equity Incentive Plan, that he would forfeit or lose the options. [73]

Gabriel contended that the real risk of forfeiture test in section 83A-105(3)(b)(i) of the ITAA 1997 is silent as to whether it is to be applied objectively or subjectively, and that the assessment of 'a real risk' requires a consideration of the employment in which the Plan operated, as well as the character or nature of the taxpayer's employment and his previous employment history.

Gabriel stated that as at 8 November 2013, he was not of the view and had no reason to be of the view that there was a real risk that under the conditions of the 2008 Equity Incentive Plan, he would forfeit or lose the options. He also submitted that prior to being employed by Cloudera, Inc., he was employed in his previous roles for much longer periods of time, being 5, 3, 11, 8 and 5.5 years.[74]

The Commissioner submitted that the meaning of 'a real risk' for the purposes of Division 83A, is an objective test rather than a subjective test.[75] The test is whether objectively there is an actual possibility of forfeiture or loss of the ESS interest that is more than a mere possibility or rare eventuality. The Commissioner relied on a definition of 'real risk' from the case of *Overseas Tankship (UK) Ltd v The Miller Steamship Co Pty Ltd (The Wagon Mound (No 2))* [1966] UKPC 1 being 'one that a reasonable person would not brush aside as being far-fetched or fanciful' and the Explanatory Memorandum to the *Tax Laws Amendment Act (2009) Budget Measures No.2 Bill 2009* in support of his construction.[76]

The AAT held that Gabriel's options were subject to a real risk for forfeiture.[77]

---

[66] [2020] AATA 4667 at [19].
[67] Ibid.
[68] Ibid at [21].
[69] Ibid at [20].
[70] Ibid at [22].
[71] Ibid at [23].
[72] Ibid at [24].
[73] Ibid.
[74] Ibid at [28].
[75] Ibid at [39].
[76] Ibid.
[77] Ibid at [64].

The AAT considered that it was misguided to focus on whether the assessment of a real risk was objective or subjective.[78] Instead, it is simply necessary to assess the risk, and the question is whether the 2008 Equity Incentive Plan conditions posed a real risk of forfeiture. In considering the conditions of the 2008 Equity Incentive Plan, relevant facts may include the wording of the scheme that gives rise to those conditions and circumstances that arise from those conditions.[79]

The AAT considered that the Grant Notice and the terms of the 2008 Equity Incentive Plan provided that the options granted to Gabriel were subject to the following conditions as at 8 November 2013:[80]

1. effluxion of time commencing one year from the Vesting Commencement Date, 14 October 2013; and
2. extinguishment of the grant under the Plan at termination of employment before each of four years from that date.

These conditions meant that there was a real risk of forfeiture.[81]

The AAT considered that, whilst Gabriel's past work history may be a circumstance that affects the risk of termination, it did not surmount the countless ways in which Gabriel could cease employment in the course of one year, let alone an assessment of each of four years.[82]

TRAP – the ATO website sets out that there are scheme conditions that they consider do not lead to a real risk of forfeiture, such as short vesting periods (less than 6 months is the example given) or meeting clearly achievable targets – see https://www.ato.gov.au/General/Employee-share-schemes/In-detail/Restrictions-and-forfeiture/ESS---Real-risk-of-forfeiture/

2.4 Taxed on discount twice due to confused employer

For employees, they are often dependent on their employer reporting for the employee share scheme interest. This can be problematic for a number of reasons:

1. some employers are not aware of their reporting obligations or, perhaps, choose not to report, particularly employers that do not have fixed establishments in Australia. This is an increasing problem given the growth of flexible working arrangements since the COVID-19 pandemic;
2. employers do get it wrong. This places the employee in a very difficult position as the ESS reporting by the employer is used as a data file by the ATO and the writer's experience is that it is extremely difficult to get the ATO to accept the employer reporting is wrong, even when it is clearly wrong.

The following example demonstrates errors that can be made by employers.

An employee was issued with several tranches of options and rights in her employer from 2011 onwards. Under the rules in Division 83A prior to 1 July 2015, the tranches that were issued prior to 1 July 2015 had a deferred taxing point of vesting i.e. when the employee became entitled to exercise the options, but the tranches issued after 1 July 2015 had a deferred taxing point of exercise, putting aside any deferred taxing point for termination of employment.

The employer initially failed to identify the deferred taxing point on vesting for the pre-1 July 2015 interests but some years later issued ESS statements, belatedly, for all relevant years. These ESS statements disclosed the

[78] [2020] AATA 4667 at [56].
[79] Ibid at [57].
[80] Ibid at [63].
[81] Ibid at [64].
[82] Ibid.

discount as at the vesting date. The employee amended all prior year assessments to the extent that they were within the period capable of amendment under section 170 of the ITAA 1936.

The employee did not exercise the options or rights as they vested but exercised them in a later year. By this time, the employer had changed tax advisers (from one Big 4 accounting firm to another Big 4 accounting firm) and the tax adviser mistakenly treated all of the ESS interests has having a taxing point of exercise. As a result, the employee received ESS statements for ESS interests that had already been reported in ESS statements in earlier income years.

Once the employee exercised the options/rights, she sold them within 30 days. As she had not held the shares for 12 months and these were not options issued pursuant to the start-up concessions, the CGT 50% discount was not available. Further, the employee's cost base of the ESS interests was the market value at the time of vesting, plus any price paid to exercise the options, which was substantially less than the market value of the ESS interests at the time of exercise.

3. Common models for incentivising employees

3.1 Issue or transfer of shares

Under such an employee share scheme, eligible employees are issued or transferred shares. Shares could be issued or transferred immediately but subject to vesting conditions. Alternatively, shares can be issued or transferred in tranches on the fulfilment of certain performance conditions.

The grant of a share to an employee is an ESS interest and can be subject to upfront or deferred taxation under the ESS scheme depending on the terms of the share option plan.

3.2 Options

Under an employee share option plan, eligible employees are issued with options which can be exercised on the fulfilment of certain conditions by paying an exercise price. The exercise of the option would entitle the employee to acquire shares in the Company.

The exercise price could be pre-determined, or be equivalent to the market value of the shares at the time of the grant.

The grant of an option to an employee is an ESS interest and can be subject to upfront or deferred taxation under the ESS scheme depending on the terms of the share option plan. Getting concessional tax treatment under Division 83A is easier for options as certain requirements do not apply to a beneficial interest in a right as compared with a beneficial interest in a share. An example of this is the broad availability requirement that is needed for deferred taxation, including the start-up concessions.[83]

The key advantage of a share option is that it is relatively straight forward to implement and allows a Company to remunerate employees without immediate cash outflow.

A disadvantage of the share option is that there is a risk that options will not be exercised if the share price is volatile or deceased in value.

3.3 Performance rights

Under a performance rights plan, performance rights are granted to eligible employees under an incentive plan for no consideration, where the performance rights can be exercised on the fulfilment of certain performance hurdles to entitle the holder the right to acquire fully paid shares for no consideration.

The performance hurdles can be financial, non-financial, service related or a mixture of the above,

The key advantages of the Performance Rights are as follows:

1. it allows the company to remunerate without an outflow of cash at the commencements of the plan;
2. it provides flexibility and certainty around the taxing point

[83] *Income Tax Assessment Act 1997* (Cth), s 83A-105(d).

3.4 Cash Bonus

Under a cash bonus incentive scheme, an eligible employee receives cash bonus on achievement of performance hurdles.

This can be a simple structure but is cash flow dependent.

A cash bonus avoids some of the potentially adverse consequences of employee share schemes.

3.5 Phantom share plan

Under the Phantom Share Plan, the eligible employees would hold "Phantom Shares," which are notional shares in the company. The employees would receive a cash bonus based on their notional holding of the "Phantom Share" and their notional share value. The bonus amounts paid to the eligible employees based on their notional holding of " Phantom Share", which are equivalent to the amount the eligible employees would have received if they held a certain number of shares directly in the company.

The Phantom Share Plan can be designed to take into account the growth in capital value of the company. For instance, the eligible employees would receive a bonus payment based on the capital equivalent in a sale, liquidation or other exit event.

As the employees are not real shareholders, they have no voting rights on company matters, nor do they have the same rights as shareholders.

A Phantom Share Plan can be simple to structure but is tax dependent.

The key advantages of the Phantom Share Plan are as follows:

1. the Phantom Share Plan allows the Company to give the eligible employees a participating interest in the company without giving them an actual registered ownership in the company. The company could deal with the share capital of the Company without having regard to the eligible employees as minority shareholders;
2. the issued share capital in the company will not be diluted;
3. the company will be entitled to a tax deduction for the bonus payments made to eligible employees under the Shadow Plan; and
4. the company is not taxed up-front, rather the employees are taxed on the bonus amounts they receive (i.e. the amounts are included as assessable income in their individual tax returns).

The key disadvantages of the Phantom Share Plan are as follows:

1. the eligible employees cannot regard the Phantom Shares as real shares of the company which could be a disincentive for the employees;
2. the bonus amounts paid to the eligible employees would be subject to payroll tax and while ESS interests are subject to payroll tax, there is the potential for this to be at a lower value at the time grant;
3. the receipt of the bonus amounts by the eligible employees is not taxed on capital account (i.e. the amounts are treated as assessable income). Therefore, the CGT concessions would not be available to the eligible beneficiaries upon receiving a bonus payment on a sale, liquidation or exist event.

3.6 Loan funded share plan

Under a loan -funded employee share plan, the company provides the employee a, usually, limited recourse loan to fully or partially fund the purchase of shares at market value. The loan can be interest-free or interest bearing.

The loan can be paid off over time by dividends declared by the company and/or on an eventual liquidation event (e.g. sale or IPO). Therefore, the employees essentially get the benefit of the uplift in value from the date they are issued equity interests to the date of liquidation.

The key advantages of the loan-funded share scheme are as follows:

1. as the shares are not being issued at a discount and full market value is being paid (albeit by vendor finance), there is no upfront or deferred taxation for the employee under the ESS scheme. Division 83A does not apply at all and, accordingly, there no requirement for ATO reporting under the ESS rules;
2. there is no initial cash layout for the employee if the share issue is wholly loan financed by the Company;
3. assuming the loan is limited recourse, employees are protected from the downside risk if the share value falls below the loan balance; and
4. any uplift of share value will be taxed on capital account.

The key disadvantages of the loan funded share scheme are as follows:

1. interest-free (or low interest) loans made to employees will not be subject to Fringe Benefit Tax (**FBT**) if the employee can demonstrate that there is a reasonable expectation that the shares acquired with that loan will be used to generate assessable income, typically in the form of dividends. This relies on what is referred to as 'the otherwise deductible rule', which can operate to reduce the taxable value for FBT purposes to nil. However, this treatment is only available where the borrower is the employee personally. If the Shares were acquired by, and the loan provided to, an associate of an employee (such as their spouse or their family trust) then the otherwise deductible rule would not apply and FBT would be payable on the value of the loan fringe benefit;
2. if a participant in the loan-funded scheme is an existing shareholder or an associate of an existing shareholder of the company, a loan-funded scheme may have tax implications under the Division 7A of the ITAA 1936.[84] Complying with the requirements under section 109N of the ITAA 1936 might not align with the commercial objectives of a loan funded scheme. This is inherently a problem with a loan-funded scheme that involves shares being issued in tranches. Further, if the loan is forgiven, then the shareholder may have a deemed dividend under Division 7A by operation of section 109F of the ITAA 1936;
3. there is an additional compliance step required under the financial assistance provisions of the *Corporations Act 2001* (Cth) which must be adhered to. Compliance is fairly simple but can take time (up to 60 days before the loan and shares can be issued);
4. there is a question of whether interest will be deductible under section 8-1 of the ITAA 1997.

There may be tax implications associated with buy-backs if the company needs to buy back the shares in the event that there is a default under the loan. There are also *Corporations Act 2001* (Cth) procedures that need to be followed in such an event.

[84] This is an exception to this in section 109NB of the *Income Tax Assessment Act 1936* (Cth), however, this does not apply to all ESS interests that are taxed up-front.

Loan funded schemes were first developed, widely, for employee equity arrangements in listed companies and they do not fit as comfortably for private companies.

3.7 Flowering Share Scheme

Under a Flowering shares scheme, a special class of shares are issued immediately but with rights under the shares essentially suspended until the occurrence of a milestone event or the fulfillment of certain KPIs. It is possible to use a hybrid of a flowering share scheme and a loan funded scheme if desirable.

As the rights are initially ‘turned off’ at the time of issue, the shares typically have a market value that is less than the market value of ordinary shares. The effect of this is that the shares may be able to be issued for a price that is less than the market value for an ordinary share but with no 'discount' that would trigger up-front tax under the employee share scheme provisions.

The key advantages of the loan flowering share scheme are as follows:

1. there is no initial cash layout for the employee if the share issue is for nominal value;
2. there is a potential for low ESS tax (or no ESS tax is the market value is paid for or loan funded);
3. if appropriately structured, deferred taxation might be available; and
4. any uplift of share value will be taxed on capital account.

The key disadvantages of the loan flowering share scheme are as follows:

1. it is critical to obtain a formal valuation of the flowering shares at the outset to support the nominal value of the shares. This could add to the cost of implementing the flowering share scheme, particularly given the impact on the value of the relevant restrictions; and
2. there are complexities around the documentation and administration of the flowering share scheme.

Flowering share schemes work by restrict the rights under the shares issued to employees to reduce the value of the shares so that the “discount” on the shares is a lower amount. It is important that the employee understand that the discount is only lower because what they are receiving is worth less than what it would have been had the rights not been restricted

3.8 Employee share trusts

This involves a trust being established to hold shares and rights for the employees of an employer. In the writer's experience, employee share trusts are usually not a feasible option for private companies, particularly given the views of the ATO expressed in ATO ID 2019/13 and TR 2018/7 but also due to the cost of administering them and the potential implications under the *Corporations Act 2001* (Cth).

Employee share trusts are not further considered in this paper.

4. Common issues for advice

The issues in this section can arise for advisers of either employees or employers. For advisers to employers, the issues will often go to whether or when there is an ATO reporting obligation or an obligation to issue an employee share scheme statement.

4.1 Is there an ESS interest?

An 'employee share scheme' is a scheme under which 'ESS interests' in a company are 'provided' to employees (including past or prospective employees) or associates of employees of the company or the company's subsidiaries in relation to the employee's employment.

Shares in a company can be 'provided' by the issue of new shares or the transfer of existing shares.

An 'ESS interest' in a company is defined as a beneficial interest in:

1. a share in the company; or
2. a right to acquire a beneficial interest in a share in the company.

An ESS interest will include interests provided not just to employees but to people in employment-like relationships with the company, such as directors, office holders and independent contractors.[85]

4.2 When did the employer 'provide' the ESS interest?

Importantly, a taxing point can only arise once an ESS interest has been provided.

An ESS interest is provided at the time that a person has a contractual right to be issued with shares in a company. Further, the acquisition of a right under a contract to, later, acquire a right to acquire a beneficial interest in a share is an "indeterminate right" and once the person has the right to acquire the shares, they have taken to have that right since the creation of the indeterminate right.[86]

The ATO's view on the time that an 'indeterminate right' is acquired is set out in TD 2016/17. TD 2016/17 provides as follows:

> 2. A right that becomes a right to acquire a share when a condition of the contract is satisfied must be enforceable against the other party under the terms of the contract, even if only to the extent of the condition. The relevant condition can be one to be fulfilled by either the employee or the employer. However, the condition to be satisfied must be an essential or required precondition for the right to acquire a share being provided. That is, its satisfaction must directly cause the employee to have a right to acquire a share. This condition is a condition 'precedent to performance'.
>
> 3. A right that does not directly become a right to acquire a share when the condition precedent is satisfied, is not an indeterminate right under subsection 83A-340(1). This is the case where that right may eventually lead to, or have a distant causal connection to, the eventual acquisition of a right to acquire a share. A right that leads to, or has a distant causal connection to, the eventual acquisition of a right to acquire a share cannot be said to have 'become' a right to acquire a share.
>
> 4. Further, a right that is subject to a condition precedent to the formation of the relevant contract itself is not an indeterminate right for the purposes of section 83A-340.

[85] *Income Tax Assessment Act 1997* (Cth), s 83A-325.
[86] *Income Tax Assessment Act 1997* (Cth), s 83A-340.

TD 2016/17 provides a number of examples. The following examples assist with illustrating the position:

Example 1 - No contractual rights created

Yachts Ltd wants to set up a new employee share scheme. The CEO of Yachts Ltd meets with its employees and gives them a presentation on the features of the proposed scheme. After the presentation, the employees receive a general memorandum telling them the total number of prospective shares likely to be on offer. The memorandum also states that the remuneration board of Yachts Ltd needs to give its formal approval before the scheme can commence, and that legal advice on the exact terms of the employee share offer are yet to be finalised with the lawyers.

As no contractual rights have been created in employees at the time of the presentation or when the general memorandum is sent, nothing has been granted at this time that could be an indeterminate right.

Example 2 - A right that becomes an indeterminate right

Yachts Ltd has now finalised the terms of its employee share scheme, has obtained remuneration board approval, and the exact terms have been settled with the lawyers. Yachts Ltd intends to implement its employee share scheme in conjunction with its Short Term Incentive Scheme (STIS).

At the beginning of each financial year, under the STIS, each employee is told the potential incentive they could receive. This time around, the incentives will be a mix of rights to acquire shares in the employee share scheme and cash - at the remuneration board's discretion. The employees receive the incentive only when they have reached specific performance goals and remained with Yachts Ltd for a minimum period. Yachts Ltd determines the incentives by the August after the relevant financial year, and provides them by December in the same year.

Robbie, a Senior Executive at Yachts Ltd, is advised in July 2016 that she will be entitled to a $50,000 incentive if she meets specific performance goals. Robbie remains employed by Yachts Ltd and, in August 2017, is advised that she has achieved all of her performance goals. In December 2017, the remuneration board decides that Robbie will receive her $50,000 incentive as $10,000 cash and rights to acquire shares worth $40,000 in Yachts Ltd. Robbie receives the cash and rights in December 2017. Robbie must remain with Yachts Ltd for a further 12 months before she can exercise the rights to acquire shares, and she can obtain the shares.

In August 2017, once Robbie has satisfied her performance conditions, she has a contractual right to enforce the payment up to $50,000. She has earned her entitlement to the incentive. It is this right, which later becomes a right to acquire a share, that is the indeterminate right for section 83A-340.

Accordingly, Robbie acquired her indeterminate right, and therefore the right to acquire a share, in August 2017.

Note: Any right that Robbie may have received in July 2016 (when she was advised that she would be entitled to the $50,000 incentive if she met performance goals) did not directly become a right to acquire a share. Only in August 2017 did a right exist (the indeterminate right) that became a right to acquire a share, at which time Robbie also received something of tangible value.

Example 3 – Rights in employment contracts before the employment commences

13. Cars Ltd enters into contractual negotiations with a prospective employee for a senior executive director role. In April 2016, Cars Ltd executes an employment contract with Jules. Under the terms of the contract, Jules will commence with Cars Ltd on 1 July 2016. His remuneration will be a cash salary, plus shares and rights to acquire shares in Cars Ltd to the value of $80,000. However, the grant of shares and rights to Jules is subject to both Jules actually commencing employment, and to shareholder approval. On

1 July 2016, Jules commences employment with Cars Ltd and executes a Share Deed with Cars Ltd. Under this Deed, Cars Ltd agrees, subject to shareholder approval, that it will issue the shares and rights to Jules's family trust. On 1 December 2016, at the AGM, the shareholders approve the issue to Jules. The shares and rights are issued on 12 December 2016.

14. Although Jules obtained something of value when he executed the employment agreement in April 2016, he had no right relevant to the later acquisition of the right to acquire a share that could be enforced against Cars Limited until he commenced his employment. It was only then that Jules could enforce any rights that he may have had that related to the rights to acquire shares.

15. Therefore, Jules's right as at 1 July 2016 (and no earlier) is a right (the indeterminate right) that later becomes a right to acquire a share for section 83A-340, once shareholder approval had been obtained.

Note: If, instead, the agreement had been entered into after employment had commenced, the indeterminate right would have arisen when the agreement was made.

Example 4 – Conditions precedent to the grant of rights, and conditions precedent to the exercise of rights

16. Ashley is a manager at Trains Ltd. She has been identified as a candidate for the Trains Ltd employee share scheme. However, she must pass a number of conditions to participate, including:

(a) Ashley must remain employed with Trains Ltd for 12 months, and meet specific performance measures before being eligible to be granted a right to acquire a share.

(b) Once Ashley is eligible, Trains Ltd makes her an offer to acquire a right to acquire a share. Ashley may choose to accept this offer, and pay a small premium to Trains Ltd when she accepts the offer.

(c) However, before Trains Ltd issues rights to acquire shares to Ashley, the Remuneration Board of Trains Ltd must approve the issue (this approval is subject to its complete and unfettered discretion).

(d) If the Remuneration Board exercises its discretion in Ashley's favour, Trains Ltd can issue the rights to acquire shares to Ashley.

(e) If the Remuneration Board does not approve the issue of the rights, Trains Ltd will refund Ashley's premium.

17. Exercise of the rights is subject to further conditions. Ashley will only be able to exercise the rights and take possession of the underlying shares if:

(a) she remains in employment with Trains Ltd for three years;

(b) she meets at least 80% of her performance measures, and

(c) Trains Ltd's share price reaches a prescribed value at each annual anniversary leading up to the exercise date.

18. Ashley will lose the rights if these conditions are not fulfilled.

19. Ashley has obtained a right (the indeterminate right) that becomes a right to acquire a share at the time she accepts the offer to acquire a right and pays to Trains Ltd a small premium with the acceptance of the offer. It is at this time that a binding contract has come into existence. Until and unless Ashley accepts the offer and pays the premium, she does not obtain any rights with a sufficiently direct connection with the right to acquire shares such that it can be said they are rights that 'become' a right to acquire shares.

4.3 Timing of taxing point

An ESS Interest will either:

1. be subject to non concessional tax treatment and taxed up-front; or
2. be subject to concessional tax treatment and either:
   (a) subject to deferred taxation under Division 83A; or
   (b) not subject to tax under Division 83A by operation of the start-up concessions.

4.3.1 Up-front taxation

The default taxing regime for an ESS interest is up-front taxation. Section 83A-20 of the ITAA 1997 applies if a taxpayer acquires an ESS interest under an employee share scheme at a 'discount',[87] and either the deferred taxation rules do not apply or the amount is not reduced under other concessions, with the key being the start-up concessions.[88]

The term discount is not defined in the ITAA 1997 but it takes its ordinary meaning as being less than the market value.

Where up-front taxation applies, the taxpayer's assessable income for the income year in which they acquire the ESS interest includes the discount given in relation to the interest.[89]

4.3.1.1 Start-up concessions

It is not the intent of this this paper to set out all of the requirements for the start-up concessions. However, it is worth noting the following requirements:

1. the person to whom the ESS interest is provided must not, immediately after they acquire the ESS interest, aggregated with their associates, hold a beneficial interest in more than 10% of the shares in the company and must not be in a position to cast or control the casting of more than 10% of the votes at a shareholders meeting for the company.[90] For this rule, a person is deemed to own the shares for which they hold a right to acquire and that right is an ESS interest (**10% Threshold**);[91]
2. where the ESS interest is a beneficial interest in shares, the discount on the ESS interest must be no more than 15% of market value at the time that the interest acquired;[92]
3. where the ESS interest is a beneficial interest in a right to acquire shares, the exercise price must be no less than the market value of the shares at the time the right was acquired.[93]

Where the start-up concessions apply, there is no tax under Division 83A of the ITAA 1997. Instead, tax is only imposed at the time that either the options are sold or, where the options are exercised, the shares are sold. Where the options are exercised, the resulting shares acquired are deemed to have been acquired at the time

[87] *Income Tax Assessment Act 1997* (Cth), s 83A-20.
[88] *Income Tax Assessment Act 1997* (Cth), s 83A-33, s 83A-35 & s 83A-105.
[89] *Income Tax Assessment Act 1997* (Cth), s 83A-25.
[90] *Income Tax Assessment Act 1997* (Cth), s 83A-45(6).
[91] *Income Tax Assessment Act 1997* (Cth), s 83A-45(7).
[92] *Income Tax Assessment Act 1997* (Cth), s 83A-33(5)(a).
[93] *Income Tax Assessment Act 1997* (Cth), s 83A-33(5)(b).

that the options were acquired for the purpose of determining whether the person owned the shares for 12 months in order to access the CGT 50% discount.[94]

4.3.2 Deferred taxation

Several conditions must be satisfied in order for deferred taxation to an ESS interest acquired at a discount apply as follows:

1. the start-up concessions do not apply;
2. the relevant employee is employed by the company or a subsidiary of the company;
3. all interests under the scheme relate to ordinary shares;
4. certain integrity rules concerning companies that engage in share trading and investment are not triggered;
5. the 10% threshold is not exceeded;
6. in relation to an ESS interest that is a beneficial interest in a share:
   (a) the broad availability condition is satisfied;[95] and
   (b) there is a real risk of forfeiture or it is an eligible salary sacrifice arrangement;[96] and
7. in relation to an ESS interest that is a beneficial interest in a right to acquire a share:
   (a) there is a real risk of forfeiture or at the time that the interest was acquired or the resulting share upon exercise of the right;[97] or
   (b) the scheme genuinely restricted the employee from immediately disposing of the right, the governing rules of the scheme expressly stated that Subdivision 83A applied to the scheme.[98]

Where deferred taxation applies, the deferred taxing points are as follows:

ESS interest that is a share **Earlier of the following[99]**	**ESS interest that is a right to acquire a share** **Earlier of the following[100]**
No real risk forfeiture and no genuine disposal restrictions	Right has not been exercised and there is: (a) no real risk that the right will be forfeited (other than by disposing, exercising or letting the right lapse); and (b) any disposal restrictions no longer apply
15 years from when acquired	15 years from when acquired

[94] *Income Tax Assessment Act 1997* (Cth), s 115-30(1), Item 9A.
[95] *Income Tax Assessment Act 1997* (Cth), s 83A-105(1)(c)(i).
[96] *Income Tax Assessment Act 1997* (Cth), s 83A-105(1)(c)(ii).
[97] *Income Tax Assessment Act 1997* (Cth), s 83A-105(1)(d)
[98] *Income Tax Assessment Act 1997* (Cth), s 83A-105(1)(d).
[99] *Income Tax Assessment Act 1997* (Cth), s 83A-115(2).
[100] *Income Tax Assessment Act 1997* (Cth), s 83A-120(2).

	Right has been exercised and (a) no real risk that the shares will be forfeited (other than by disposing of it); and (b) any disposal restrictions in relation to the shares no longer apply

If the ESS interest is disposed of within 30 days of the relevant taxing point, other than by exercise, the taxing point is the time of disposal.

4.3.3 Ordinary shares

One of the requirements for deferred taxation, and the start-up concessions, is that the shares be ordinary shares. The ATO takes a generous view on what is an ordinary share for this purpose, stating in ATO ID 2010/62 as follows

> *Whether a share is an ordinary share in a company for the purposes of the condition in subsection 83A...of the ITAA 1997 is to be determined by considering the rights attached to the share in relation to distributions of profits and capital and on winding up of the company, as compared to other shares in the company. Shares that have a priority as to dividends or distributions in the event of winding up are preference shares. If shares are not preference shares, they are ordinary shares (emphasis added).*

This was considered in a recent private ruling.[101]

The facts were as follows:

Company A is a company based in Country A.

Company B is a wholly owned subsidiary of Company A and employs Australian resident individuals.

Company A has ordinary A and B shares on issue as well as preference shares.

B Shares rank equally with the A Shares on issue as to rights to dividends and surplus on winding up, but do not carry voting rights.

The preference shares have a priority to distributions in the event of winding up.

Company A has an employee share plan under which it has granted options to Australian resident employees of Company B. If the Options vest the Australian resident employees will be issued with B shares following the exercise of the Options on or before the expiry date.

The ATO noted that satisfaction of section 83A-45(2) of the ITAA 1997 is one of the conditions required for the start-up concession or the deferral concession in the employee share scheme provisions to apply.

Citing ATO ID 2010/62, The ATO considered that the B shares were 'ordinary' shares for the employee share scheme provisions as:

1. the B shares entitled the holders the right to a distribution of the profits on a pro rata basis with the other shareholders; and

[101] PBR Authorisation Number 1051801207726 (at w https://www.ato.gov.au/law/view/document?docid=EV/1051801207726.)

2. upon liquidation entitled the holders of the B shares to a return of proceeds equal in proportion to the holders of the other shares, even though it is only after the preference shares receive their returns that the A and B class shareholders receive a return of capital.

The ATO considered that the lack of voting rights did not prevent the B shares from being ordinary shares for the purpose of the employee share scheme provisions.

4.4 Is there a discount?

If there is no discount in relation to the ESS interest at the time that the ESS interest is provided, then the ESS rules in Division 83A do not apply. Importantly, amongst other things, this means that, in the case of an ESS interest that would otherwise have a deferred taxing point, even if there is a discount at the deferred, no amount is included in the assessable income of the employee. Further, there are no reporting obligations on the employer under the ESS reporting rules if Division 83A does not apply.

It will often be contended that there is no discount at grant. This will ultimately be a consideration of market value. In a practical sense, valuation issues are often at the forefront of employee share schemes. This paper does not deal with valuation issues, other than to make the following observations:

1. section 960-400 of the ITAA 1997 states that the expression "market value" is used in the income tax laws with its ordinary meaning. The effect of this is that market value is determined in accordance with the ordinary principles set out by the High Court in *Spencer v the Commonwealth* (1906) 5 CLR 418, where the High Court held that a valuation of land for the purposes of a resumption statute should be based on the price that a willing purchaser at the date in question would have had to pay to a vendor not unwilling, but not anxious, to sell. In *Spencer* Isaacs J made the following comments on the concept of market value

   > "… to arrive at the value of the land at that date, we have … to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land and cognisant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood as then appearing to persons best capable of forming an opinion, of a rise or fall for what reasons so ever in the amount which one would otherwise be willing to fix as to the value of the property."

2. the *Spencer* test is not an easy one to apply in practice but it appropriate to summarise it is as involving the following:

   (a) an assessment as to the highest and best use of the asset;

   (b) a willing but not anxious vendor and purchaser;

   (c) the determination of a hypothetical market;

   (d) an assumption that the parties have sufficient information in relation to the asset; and an assumption that the parties are aware of current market conditions;

   (e) events occurring after the transaction do not affect value. That is, market value should not be determined with the benefit of hindsight.

3. in respect of employee share scheme interests, there are special valuation rules that apply for the purpose of the employee share scheme provisions, including the following

(a) in respect of listed shares, the ATO will accept any reasonable method for determining the market value such as the weighted average actual price method, the weighted average closing price method, the average cost of shares method or the closing price method;[102]

(b) for rights to acquire unlisted employee share scheme interests, the *Income Tax Assessments Regulations 1997* (Cth) prescribe a voluntary manner in which the value of an ESS interest can be determined; and

(c) for employee share scheme interests that are subject to the start-up concessions, in determining whether the price being paid meets the valuation requirements, the Commissioner has issued a legislative instrument under section 960-412(2) of the ITAA 1997, permitting 1 of 2 safe harbour valuation methodologies to be adopted. Importantly, this allows a valuation on a net tangible asset based. That is, without regard to goodwill or intellectual property.

4. seeking to get employee share scheme interests immediately *before* an expected capital raise will rarely be that relevant, except where the safe harbour valuation under the start-up concessions is sought to be relied upon. While a price subsequently paid by investors in capital raise should not be evidence of value before the capital raise, absent other compelling evidence of value, it is very likely that the price paid by third party investors will likely be seen as a strong indication of value.

4.5 ESS discount for employment outside of Australia

It is sometimes necessary to consider how the ESS rules operates where the deferred taxing point happens while the employee is a resident of Australia but the ESS interest relates, at least in part, to a period of foreign employment.

The ATO's approach can be seen from a recent private ruling.[103]

The facts were as follows.

The taxpayer is a temporary resident for tax purposes.

The taxpayer received shares in a foreign company that is the holding company of his or her employer.

The taxpayer received the rights just after he or she had moved to Australia and they had a deferred taxing point three and a half years later, being the 2019-20 income year.

The terms of the grant of the rights indicated that the reference period for the rights would be three years beginning at the start of the calendar year in which the rights were granted.

The taxpayer's employer reported the ESS discount for the 2019-20 income year on the basis that the whole of it is assessable in Australia.

The question asked was the ESS discount assessable to taxpayer to the extent it relates to his or her employment outside Australia?

The ATO ruled no.

The ATO noted that section 83A-110(2) of the ITAA 1997 provides as follows:

[102] https://www.ato.gov.au/businesses-and-organisations/corporate-tax-measures-and-assurance/employee-share-schemes/in-detail/market-value/market-value-of-listed-shares-and-stapled-securities
[103] PBR Authorisation Number: 1051817833098 (at https://www.ato.gov.au/law/view/document?docid=EV/1051817833098)

> Treat an amount included in your assessable income under subsection (1) as being from a source other than an Australian source to the extent that it relates to your employment outside Australia.

The ATO noted that ESS interests (including rights to acquire shares) are statutory income if they are assessable at the deferred taxing point and that section 768-910(1) of the ITAA 1997 provides that statutory income (other than a net capital gain) derived by a temporary resident from a source other than an Australian source is s 'non-assessable non-exempt income'.

Section 6-15(3) of the ITAA 1997 states that amounts are not assessable income if they are non-assessable non-exempt income.

Accordingly, the ATO accepted that the ESS discount, to the extent it relates to his or her employment outside Australia, was not assessable to the taxpayer.

The ATO then considered the approach to working out the Australian and foreign portions of the ESS discount.

The ATO referred to the Explanatory Memorandum to the *Tax Laws Amendment (2009 Budget Measures No. 2) Act 2009* (Cth) which stated

> 1.352 The apportionment between foreign sourced and Australian sourced income is to be done in a manner consistent with Organisation for Economic Development and Cooperation (OECD) practice, as explained in the Explanatory Memorandum to the New International Tax Arrangements (Foreign-owned Branches and Other Measures) Bill 2005.
>
> ,,,
>
> 1.354 Whether the discount on the ESS interest acquired under an employee share scheme relates to employment in Australia or outside Australia is a question of fact that needs to be determined on a case-by-case basis.

The ATO referred to the following statements from the OECD commentary on Article 15 (about employment) as being an aid to determining the employment period:

> 12.7 The first principle is that, as a general rule, an employee stock-option should not be considered to relate to any services rendered after the period of employment that is required as a condition for the employee to acquire the right to exercise that option. Thus, where a stock-option is granted to an employee on the condition that he provides employment services to the same employer (or an associated enterprise) for a period of three years, the employment benefit derived from that option should generally not be attributed to services performed after that three year period.
>
> ...
>
> 12.11 The second principle is that an employee stock-option should only be considered to relate to services rendered before the time when it is granted to the extent that such grant is intended to reward the provision of such services by the recipient for a specific period. This would be the case, for example, where the remuneration is demonstrably based on the employee's past performance during a certain period or is based on the employer's past financial results and is conditional on the employee having been employed by the employer or an associated enterprise during a certain period to which these financial results relate. Also, in some cases, there may be objective evidence demonstrating that during a period of past employment, there was a well-founded expectation among participants to an employee stock-option plan that a part of their remuneration for that period would be provided through the plan by having stock-options granted at a later date. This evidence might include, for example, the consistent practice of an employer over a number of years, as long as there was no indication that this practice might be discontinued. Depending on other factors, such evidence may be highly relevant for purposes of determining if and to what extent the stock-option relates to such a period of past employment.

> ...
>
> 12.13 Finally, there may be situations in which some factors may suggest that an employee stock-option is rewarding past services but other factors seem to indicate that it relates to future services. In cases of doubt, it should be recognised that employee stock-options are generally provided as an incentive to future performance or as a way to retain valuable employees. Thus, employee stock-options are primarily related to future services. However, all relevant facts and circumstances will need to be taken into account before such a determination can be made and there may be cases where it can be shown that a stock-option is related to combined specific periods of previous and future services (e.g. options are granted on the basis of the employee having achieved specific performance targets for the previous year, but they become exercisable only if the employee remains employed for another three years).

The ATO notes that ordinarily, the employment period (or earning period) will be the period from the grant of the rights until they vest (can be exercised by the holder of the rights).

In this instance, the taxpayer's employer nominated a 'reference period' as the three calendar years. However, the ATO noted that the rights only vest and become exercisable sometime after the end of the three year reference period and that the additional period is also part of the earning period.

Accordingly, the ATO considered that the earning period will at least include the period from 1 January in the grant year to the vesting date.

The ATO considered that there was insufficient information to determine whether any additional period can be added to the start of the reference period under the second principle in the OECD Commentary.

4.6 Interaction with CGT rules

After acquiring the interest, the employee is ordinarily taxed on capital account in relation to any later gains or losses made, which means that if the ESS interest is held by an individual or trust, a gain is made, and the relevant ESS interest is held for more than 12 months, then the CGT general discount should be available to reduce any taxable capital gain by 50%.

Where the ESS interest is a right to acquire shares in the company (e.g. an option), the resulting share will only be treated as having been acquired from the time of exercise, unless the option was subject to the start-up concessions as noted above. However, the cost base of the resulting shares in based on the market value at the time of the taxing point. The effect of this is that, if exercise of the option does not occur at the time of the taxing point, there may be an unrealised capital gain on the share and no CGT 50% discount available until the resulting share is held for 12 months. This provides a tax incentive to exercise the option as close to the taxing point as possible. However, the commercial consideration is ordinarily the need to fund the exercise price.

5. Payroll tax and employee share schemes

In this section, the "**Uniform PTA**" is used to refer to provisions of the Payroll Tax Act of New South Wales, Victoria, Tasmania, South Australia, Queensland, Australia Capital Territory and Northern Territory. While Queensland is part of the harmonised regime, its Payroll Tax Act does not adopt the same section references as the other harmonised States. References are made to the equivalent Queensland provisions where necessary. Western Australia is not part of the harmonised regime but the equivalent section references are also cited.

It is the writer's experience that the payroll tax implications of employee share schemes are often not considered by employers in designing or implementing employee share schemes. This is problematic as there are timing considerations for payroll tax in relation to employee share schemes.

The treatment of employee share scheme interests under the Uniform PTA has a number of differences to how ESS interests are treated for income tax. This leads to confusion for advisers.

5.1 Taxing point

Under the Uniform PTA, employers may choose to treat the ESS interest as wages in the year of grant or the year of vesting.[104] Vesting for this purpose has a different meaning to what is normally understood i.e., it does not mean when the employee become entitled to exercise its right to acquire the shares. Rather, vesting has a different meaning for shares and options as follows:[105]

1. the vesting date for a share is the earlier of:
    (a) the date when any conditions which apply to the granting the share have been met and the employee's legal or beneficial interest in the share cannot be rescinded;
    (b) the date at the end of the seven years from the date on which the share was granted; and
2. the vesting date for an option is the earlier of:
    (a) when the share to which the option relates is granted to the employee
    (b) when the right under the option to have the relevant share transferred, allotted or vested is exercised by the employee;
    (c) the end of seven years from the date on which the option was granted.

An ESS interest which has a nil value or is exempt when granted is not counted as wages when it vests.[106]

If the grant of an ESS interest is taxable and is not included in taxable wages for the financial year of grant, the employer will be deemed to have elected that the ESS interest be treated as taxable wages on vesting.[107] The

[104] *Payroll Tax Act 2007* (NSW), s 19; *Payroll Tax Act 2007* (Vic), s 19; *Payroll Tax Act 1971* (QLD), s 13R; *Payroll Tax Act 2008* (Tas), s 19; *Payroll Tax Act 2009* (SA), s 19; *Payroll Tax Act 2009* (NT), s 19; *Payroll Tax Act 2011* (ACT), s 19; *Pay-roll Tax Assessment Act 2002* (WA), s 9DB.
[105] Ibid.
[106] *Payroll Tax Act 2007* (NSW), s 20; *Payroll Tax Act 2007* (Vic), s 20; *Payroll Tax Act 1971* (QLD), s 13S; *Payroll Tax Act 2008* (Tas), s 19; *Payroll Tax Act 2009* (SA), s 20 *Payroll Tax Act 2009* (NT), s 20; *Payroll Tax Act 2011* (ACT), s 20; *Pay-roll Tax Assessment Act 2002* (WA), s 9DC.
[107] *Payroll Tax Act 2007* (NSW), s 20; *Payroll Tax Act 2007* (Vic), s 20; *Payroll Tax Act 1971* (QLD), s 13S; *Payroll Tax Act 2008* (Tas), s 19; *Payroll Tax Act 2009* (SA), s 20 *Payroll Tax Act 2009* (NT), s 20; *Payroll Tax Act 2011* (ACT), s 20; *Pay-roll Tax Assessment Act 2002* (WA), s 9DC.

question is whether this requires the employer to have reported the ESS interest in the monthly return or whether it is sufficient that it be included in the annual return. Unhelpfully, Revenue NSW's guidance on this provision is a little unclear as it states An employer cannot retrospectively choose grant if it did not include the value on grant in its monthly payroll tax return or annual reconciliation immediately following the grant.[108]

The choice of using grant or vesting can lead to very different payroll tax outcomes. Consider the following example:

> A US company granted 30,000 options to one of its Australian employee in on 21 April 2020. At time, market value of the shares was US$2.74.
>
> The options vested monthly over 3 years.
>
> The employer did not include the value of options in payroll tax in April 2020 payroll tax return or annual reconciliation
>
> On 21 May 2023 employee exercised all of the options at one time. At this time, the market value of shares was $127.50.

In respect to options, given that the vesting day will often be the date of exercise by the employee, this means, in effect, it is the employee that determines the taxing point (and the value to be included in taxable wages) for the employer.

5.2 Value of taxable wages for ESS interest

Under the Uniform PTA, the ESS interest must be valued using ordinary market value principles or the value prescribed by section 83A-315 of the *Income Tax Assessment Act 1997* (Cth) and Division 83A of the *Income Tax Assessment Regulations 1997* (Cth). The provisions of the Uniform PTA do not permit the employer to use the safe harbour valuation methodology for start-up companies. However, Victoria has issued public guidance permitting employers to use that safe harbour valuation methodology when the start-up concessions are being applied to the grant of the ESS interest.[109] New South Wales expressly does not permit employers to use the safe harbour valuation methodology.[110] The writer is not aware of any other State that follows the Victorian approach.

5.3 Indeterminate rights

Indeterminate rights are treated differently for payroll tax than for income tax. For income tax, indeterminate rights are only treated as being a grant of an ESS interest once it becomes certain that the rights will be satisfied by the employer issuing the shares. However, the ITAA 1997 then deems them to have always been granted at the time that the indeterminate right was first granted.[111] In contrast, for payroll tax, an indeterminate right is only an ESS interest when the share or option is actually granted.[112] There is no retrospective treatment.

[108] See, for example, Commissioner's Practice Note CPN 013 (which can be found at https://www.revenue.nsw.gov.au/help-centre/resources-library/cpn/cpn013) and State Revenue Office website guidance at https://www.sro.vic.gov.au/shares-and-options.
[109] State Revenue Office website guidance at https://www.sro.vic.gov.au/shares-and-options.
[110] Commissioner's Practice Note CPN 013 (which can be found at https://www.revenue.nsw.gov.au/help-centre/resources-library/cpn/cpn013).
[111] *Income Tax Assessment Act 1997* (Cth), s 83A-340(2).
[112] See Commissioner's Practice Note CPN 013 (which can be found at https://www.revenue.nsw.gov.au/help-centre/resources-library/cpn/cpn013).

6. Employer reporting and withholding

6.1 Reporting

Under section 392-5(1) of the Schedule 1 of the *Taxation Administration Act 1953* (Cth) an entity that must, for a financial year, give:

1. an employee share scheme statement the employee by 14 July of the following financial year; and
2. the Australian Taxation Office Employee Share Scheme Annual Report to the ATO by 14 August in the following financial year,

in the event of either of the following:

1. both of the following apply:[113]
   (a) the entity issued ESS Interests to its employees or the employees of a subsidiary in the financial year;
   (b) Subdivision 83A-B or 83 -C of the ITAA 1997 (about employee share schemes) applies to the interests; or
2. all of the following apply:[114]
   (a) the provider has provided ESS interests to the individual (whether during the year or during an earlier year);
   (b) Subdivision 83A-C of the Income Tax Assessment Act 1997 (about employee share schemes) applies to the interests;
   (c) the ESS deferred taxing point for the interests occurs during the year.

Oddly, section 392-5(1) of Schedule 1 of the TAA, on its face, requires the statement and annual report to be given for a deferred scheme both in the year of grant and in the year that the deferred taxing point occurs. In the writer's experience, this is not the usual practice and, consistent with the public guidance given by the ATO,[115] the usual practice is that reporting only occurs in the following circumstances:

1. in relation to an ESS interest that is issued at a discount and which is taxed up-front, the year in which the ESS interest is granted;
2. in relation to an ESS interest that is issued under the start up concessions in Subdivision 83-C of the ITAA 1997, the year in which the ESS interest is granted;
3. a deferred taxing point happens to an ESS interest under a tax deferred employee share scheme, irrespective of whether the ESS interest was granted in the financial year or a prior financial year.

The ATO's public guidance,[116] consistent with this, states as follows:

---

[113] *Taxation Administration Act 1953* (Cth), s 392-5(1)(a).
[114] *Taxation Administration Act 1953* (Cth), s 392-5(1)(b).
[115] See guidance given by the ATO at https://www.ato.gov.au/businesses-and-organisations/corporate-tax-measures-and-assurance/employee-share-schemes/in-detail/employer-reporting-requirements/reporting-requirements-for-employers.
[116] Ibid.

ESS statement

You must give your employee an ESS statement if:

- they or their associates, have acquired ESS interests under a taxed-upfront ESS at a discount during the financial year
- a deferred taxing point for ESS interests acquired under a tax-deferred ESS, or a cessation time for shares and rights acquired before 1 July 2009, happened or could have happened in the financial year
  - the latest possible deferred taxing point for these interests was 30 June 2019
  - this means there will be no income reportable on these interests in the 2019–20 income year and onwards
- a start-up concession acquisition event occurred, you must provide your employee with the following information about ESS interests acquired during the income year
  - number of ESS interests acquired
  - market value of ESS interests acquired
  - acquisition price of ESS interests that are shares
  - exercise price of ESS interests that are rights
  - acquisition date of the ESS interests.

However, the writer is aware of a private binding ruling in which the ATO confirms that, for a deferred scheme, the reporting is required both in the year of grant and in the year that the deferred taxing point happens.[117]

The writer is aware that some accounting firms, in order to ensure strict compliance with the law, have sought to report deferred ESS interests on grant but the ATO forms do not allow for this easily. It may be that, as section 392-5(2) of Schedule 1 of the TAA provides that the statement must be in the approved form, and there is no approved form for reporting deferred interests on grant, it is arguable there is no such requirement to report, notwithstanding section 392-5(1) of Schedule 1 of the TAA. Such a construction seems generous.

The reporting dates are not dependent on an entity's income tax year. That is, the reporting dates would be the same even if the Company has, for example, a 31 December year end.

An administrative penalty applies to providers who fail to provide the statement.[118]

6.2 Withholding for an ESS interest

A provider must pay TFN withholding tax (at the highest marginal rate plus 2%) where the provider provides an ESS interest under an employee share scheme, an amount is taxed under Division 83A of the ITAA 1997 in an income year and the employee has not quoted their TFN or their ABN to the provider by the end of that income year.[119]

---

[117] See *Private Binding Ruling* Authorisation Number 1051997007794 (at https://www.ato.gov.au/law/view/document?docid=EV/1051997007794)
[118] *Taxation Administration Act 1953* (Cth), sch 1 s 286-75(2BA).
[119] *Taxation Administration Act 1953* (Cth), sch 1 s 14-155; *Income Tax (TFN Withholding Tax (ESS)) Act 2009* (Cth), s 4.

7. Final observations

The decision in *Fox* mentioned above is just one example of the risks for employees associated with employee share schemes. Part of the problem with employee share schemes is that they are drafted from the perspective of the employer and, because employees are generally receiving the interests for "free", the risks associated for the employees are often not properly considered.

Some further observations to make:

1. there is no general principle that a deferred scheme is preferred to an up-front scheme. it depends on the individual circumstances of the employee and the assessment as to the expected value of the shares in the future;

2. a proposal that works in the circumstances of one company may not work in the circumstances of another. An example of this is that employee share schemes for public companies, a mentioned above, may use a loan funded scheme This model, when adopted for private companies without understanding that it can give rise to risks for employees under Division 7A of the ITAA 1936 can be problematic;

3. while the design of the scheme is key, the tax implementations do not follow just from the design of the scheme, but how the scheme is implemented, including the decisions that the employees makes in relation exercise and sale; and

4. the tax position of an employee will often be determined, in practical terms, by the manner of reporting by the employer on the employee's employee share scheme statement as the cost for the employee in having the employee scheme statement reviewed is usually prohibitive.