

01 Profound shift in Government policy on taxation of employee share schemes – the details

The Government has announced new measures to remove the “inconsistency” which currently exists between the two types of employee share schemes: qualifying shares schemes and non-qualifying share schemes.

As a result, employees acquiring shares or options under qualifying employee share schemes will no longer be able to defer taxation on their equity to a later time.

The Government will also limit access to the \$1,000 upfront concession to those employees with a taxable income of less than \$60,000 after adjustment for fringe benefits, salary sacrifice and negative gearing losses.

These measures will apply to shares and options acquired after 7.30pm on 12 May 2009. However, the measures will not affect shares or options already held by employees.

While the Government says it fully appreciates the benefits provided by employee share scheme arrangements, it states that these benefits must be balanced against the need to provide equitable outcomes for all employees.

02 Issues and challenges

Our initial reaction to the announcement is as follows:

- The Government's proposal fails to recognise the real benefits of option and share arrangements in terms of aligning employee and company/shareholder interests and what it adds ultimately to business and therefore the economy.
- Typically such plans do not allow the employee to sell their shares for several years. Similarly, option awards do not often become exercisable for many years. Yet with each of these alternatives the Government has announced a taxing point – at grant – before any benefit has been realised.
- Perversely, due to the interaction with capital gains tax rules, employees of successful companies will potentially have a lower overall tax bill arising from these new arrangements which would not seem to be the Government's intention.
- If the Government wished to address the issue of inconsistent tax treatment between qualifying and non-qualifying plans there are other ways of achieving this.
- The notion that some employees are able to avoid paying tax by using the deferral method of assessment and then not declaring the value at the appropriate time is questionable. Furthermore, the proposal to remove the ability to defer the taxing point will not resolve this perceived avoidance. Clearly, employees could equally not declare the taxable value in the year in which the shares or options are granted.
- A significant period of uncertainty will exist while interested parties frantically lobby the Government, Opposition and Independent members of Parliament to have the announcement either reversed or significant changes made to it.
- Employers will not wish to make new offers using options and shares due to the upfront taxation, nor move to other less attractive arrangements, until the lobbying phase and legislative processes have taken their course. In other words, a state of paralysis will exist for some time.
- Plans that are popular, being performance rights plans and salary sacrifice share plans, will have to be completely rethought if the announcement is enacted as law.
- Australia is now out of step with most other OECD countries thereby making it difficult to attract talent to Australia and out of step with the views of global regulators that incentives should be paid over an extended period.
- The proposal would make it tougher for employers generally to attract, retain and motivate talent particularly where cash is tight and non-cash remuneration is vital to fill the place of cash. In particular, this will be a significant issue for start up companies and other venture capital enterprises.
- \$1,000 tax exempt plans are likely to disappear as many people will now not qualify for the concession with the \$60,000 threshold set so low. Indeed, most commentators agree the \$1,000 concession should be increased to, say, \$5,000.

03 What you should consider

In light of the above, there are a range of things that you should consider:

- delaying making equity offers until the law is passed so you can assess the best alternative available at the time.
- revisiting use of options that are either out of the money or are short dated so that they do not have a significant discount built in.
- offering deferred cash that may convert to equity at a future date, that is, once the tax position is clear.
- although not viewed positively by external stakeholders, revisit the use of loan funded share plans.
- using plans where the equity instrument is determined at the vesting date not at grant, eg company determines whether cash or shares are issued when hurdles are met.
- offering cash combined with equity – cash is paid up-front to pay the tax with a cash claw back if hurdles are not met.
- for pre-existing plans where offers have already been made to employees, consider how the new rules apply to them and whether tax deferral is still possible, eg with salary sacrifice arrangements.
- reviewing existing contractual obligations to deliver equity that may be impacted.
- communicating with employees around the potential changes.
- above all starting to lobby Government/Senate for change.

Clearly, the Government has drawn a big line in the sand. We now await the reaction from employer, employee and shareholder lobby groups.

How PwC can help

To have a deeper discussion about what these changes mean for your business, please contact:

Sydney

Debra Eckersley
Partner
(02) 8266-9034
debra.eckersley@au.pwc.com

John Fauvet
Partner
(02) 8266-8120
john.fauvet@au.pwc.com

Brett Feltham
Director
(02) 8266-9375
brett.feltham@au.pwc.com

Emma Grogan
Director
(02) 8266-2420
emma.grogan@au.pwc.com

Melbourne

Andrew Lazar
Partner
(03) 8603-3685
andrew.lazar@au.pwc.com

Della Conroy
Partner
(03) 8603-2999
della.conroy@au.pwc.com

Justin McLean
Partner
(03) 8603-3352
justin.mclean@au.pwc.com

Daryl O'Callaghan
Director
(03) 8603-2841
daryl.ocallaghan@au.pwc.com

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