Exposure Draft of Employee Share Scheme Legislation

Submission by Ernst & Young

31 August 2009
Contents

1. Executive summary ...............................................................................................................................1
2. Detailed comments on the Exposure Draft ..............................................................................................4
3. Other issues .......................................................................................................................................15
4. Comments on specific aspects of Government policy ............................................................................16
1. Executive summary

Ernst & Young is pleased to provide this submission to Treasury on the Exposure Draft (ED) of legislation on the taxation of employee share schemes released on 14 August 2009.

The focus of this submission is to highlight the key technical issues identified by Ernst & Young and, where appropriate, recommend modifications to the ED (or to the accompanying Explanatory Memorandum (EM) to ensure the final legislation does not give rise to any unintended consequences from both a tax and policy perspective.

The key technical issues identified and our recommended modifications (where applicable), and supporting rationale for each, are summarised in the table below.

Detailed comments on each element are provided in section 2.

In section 3, we have set out other technical issues Government should consider. The issues set out in this section, although not specific to the ED, are fundamental to the effective operation of the proposed legislation and were flaws in the existing legislation contained in Division 13A of the ITAA 1936 (Division 13A).

In section 4, we reiterate comments made in our earlier submissions on the taxation of employee share schemes and provide comments in relation to the tax treatment of internationally mobile employees. The purpose of our comments in section 4 is to encourage Government to revisit its approach to certain issues, which in our view, require further consideration. Specifically, these issues are:

► Removing cessation of employment as a taxing point for employee equity awards;
► Providing refunds of income tax for equity awards that are forfeited;
► Proposed changes to the taxation of cross-border employee equity awards.

We acknowledge that finalisation of many of the outstanding issues of the legislation will be an evolving process. Accordingly, we submit that an ongoing forum to discuss technical issues should be created. Ernst & Young would welcome the opportunity to provide input to such a forum and look forward to continuing to engage with Government during the consultation process.
<table>
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<th>Issue</th>
<th>Key issues identified</th>
<th>Recommended modification(s) to draft legislation</th>
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| 1. Deferred taxation point for rights 83A-115(3) | A. The wording of the draft provisions as they apply to rights is unnecessarily complex and should be simplified to avoid ambiguity. In addition, when compared to the equivalent provision for shares, the provision defining the taxing point for rights is significantly more complex.  
B. Tax can potentially arise on rights before the participant is able to realise a benefit or even where there is no benefit to realise (e.g. in the case of an ‘underwater’ option). | A. Simplify the wording in subsection 83A-115(3). For example, consider reverting to a “cessation event” listing approach (as per current Division 13A legislation), where the default taxing point is exercise of the rights and further deferral is only available where there are appropriate post-exercise disposal restrictions on the shares acquired.  
B. Consider incorporating different deferred taxing points for rights with market price exercise price versus rights with zero or below-market exercise price. |
| 2. Meaning of “real” risk of forfeiture and “genuine” disposal restrictions | A. Although the EM provides examples of conditions that would not constitute “real” risk of forfeiture, there is limited guidance on what conditions would meet the test.  
B. The ED does not define, nor does the EM discuss, restrictions that would be considered “genuinely” restrict a taxpayer from immediately disposing of shares. Therefore, it is unclear what, if any, change is intended to the requirements regarding disposal restrictions in Division 13A. | A. The EM should provide more detailed guidance on the meaning of “real” risk of forfeiture by documenting “safe harbours”.  
B. The EM should clarify whether the new test for “genuine” disposal restrictions is of a higher standard than that which applied under Division 13A. |
| 3. $5,000 limit for salary sacrifice schemes | A. Restricting the value of shares that can be acquired under a salary sacrifice plan is unnecessarily restrictive as the same outcome can be achieved by simply limiting the amount of discount that can benefit from the salary sacrifice concession to the first $5,000. The ED appears to prevent the salary sacrifice concession from applying at all where the market value of the shares exceeds $5,000 (i.e., if the market value of shares acquired exceeds $5,000 by only a small amount, the entire value of shares is taxable).  
B. The current provisions are not clear as to whether the salary sacrifice amount needs to equal the market value of the shares the individual acquires.  
C. It appears the draft provisions do not allow for post-tax contributions or matching equity awards to be offered under the same plan as that which satisfies the salary sacrifice concession requirements. This is unnecessarily restrictive and is likely to deter employers from operating broad-based employee share plans that offer employees additional equity awards for participating in the salary sacrifice plan.  
D. The requirement for salary sacrifice | A. Limit the application of subsection 83A-105(4) to the first $5,000 of discount but allow salary sacrifice plans to enable more than $5,000 to be acquired (acknowledging that the individual would be subject to tax upfront on the amount in excess of $5,000).  
B. Clarify that the $5,000 limit applies to the market value of shares acquired notwithstanding the amount sacrificed by the employee may be less than $5,000 (e.g., for plans that offer employees shares at a discount).  
C. Allow for post-tax contributions and matching equity awards to be delivered via the same scheme that meets the salary sacrifice conditions.  
D. Remove requirement that shares acquired under a salary sacrifice scheme must be provided under a separate plan. |
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| schemes to be a separate plan from other equity plans is administratively onerous for employers and does not appear to serve any specific purpose. | A. Referencing the highest marginal income tax bracket in the provision incorporating the income cap for the $1,000 tax exemption would be consistent with Government’s intention. In addition, it avoids the need to update the provisions as the relevant tax bracket increases / decreases.  
B. There are inconsistencies in the definition of the income cap in the ED and the EM. In some cases, references are made to “equal to and less than” $180,000 but in other cases “less than” $180,000 is used. | A. Align the income cap in the ED to the highest marginal income tax bracket rather than a specific number.  
B. We understand the Government’s intention is that the $1,000 tax exemption should be available to employees with adjusted taxable income of equal to or less than $180,000 (i.e., aligned to highest marginal tax bracket). Drafting errors in the ED and EM should be amended to reflect this intention to avoid confusion. |
| 4. Income cap of $180,000 for $1,000 tax exemption                   | A. There are several issues that can only be resolved on release of details on the transitional arrangements. It is imperative details are released sooner, rather than later, to ensure Government, employers and employees are able to assess the relevant consequences, given that the rules apply from 1 July 2009. | A. Provide details on the transitional arrangements that would apply.                                          |
| 5. Transitional arrangements                                        | A. The interaction between Division 83A and CGT needs to be carefully considered to prevent double taxation issues.                                                                                                  | A. Amend or insert specific Division 83A and CGT provisions to ensure alignment between income tax consequences and capital gains tax consequences. |
| 6. Interaction with Capital Gains Tax ("CGT") provisions           | A. Definitions of various terms (refer section 2.5.3) should be provided in the ED to avoid multiple interpretations arising and increased reliance on Australian Taxation Office ("ATO") pronouncements. | A. Provide definitions in the ED for “acquire”, “discount” and “permanent employees”.                          |
| 7. Definitions and clarification                                    | A. Employment income and ESS income will now be treated inconsistently for TRs.                                                                                                                                        | A. Inclusion of a provision for inbound individuals who meet the criteria to be considered TR, which will exclude from assessable income the portion of any ESS discount that relates to foreign service prior to the commencement of Australian employment. |
| 8. Interaction with Temporary Resident ("TR") provisions           | A. Inclusion of a provision for TRs.                                                                                                                                                                                   | A. Inclusion of a provision for inbound individuals who meet the criteria to be considered TR, which will exclude from assessable income the portion of any ESS discount that relates to foreign service prior to the commencement of Australian employment. |
2. Detailed comments on the Exposure Draft

Our detailed comments on the key technical issues on the ED are provided in the following sections.

2.1 Deferred taxing point for rights / options

Subsection 83A-115(3) of the ED sets out the “Employee Share Scheme (ESS) deferred taxing point” for rights and options (collectively referred to as “rights”). The ESS deferred taxing point is the new taxing point for “qualifying” ESS interests.

A. The provisions are unnecessarily complex and ambiguous

The draft provisions that define the taxing point for rights comprise four subparagraphs (83A-115(3)(a)-(d)), with a further four subparagraphs under 83A-115(3)(b). Overall, the provisions are unnecessarily complex and ambiguous.

The key issues resulting in confusion are as follows:

► The operation of subparagraphs 83A-115(3)(a) and (b) is unclear. It is unclear why both subsection (a) and (b) are required, operating independently of each other.

► The drafting of the subsection is inconsistent with the Government’s stated intention. The complexities of the deferred taxing point should be considered in conjunction with Government’s overall intention for the provisions. Our understanding of the intended deferred taxing point for rights is that provided there is a risk of forfeiture at the time the right is granted, tax can be deferred (subject to the cessation of employment taxing point and 7-year maximum deferral) until none of the following apply:

   i. The “real” risk of forfeiture;
   ii. Exercise restrictions on the rights (e.g., following an appropriate approval process for exercise); and
   iii. Post-exercise restrictions on the shares (e.g., disposal restrictions on shares acquired on exercise).

However, in our view, the draft taxing point provisions for rights do not achieve this objective. In contrast, the ESS deferred taxing point provision for shares is relatively straightforward.

► Subsection 83A-115(3) is ambiguous. A common misinterpretation of subparagraph 83A-115(3)(b) is that the requirements in (i) to (iv) should be read as cumulative (i.e., the rights must be subject to a “real” risk of forfeiture and disposal restrictions and the shares acquired on exercise must also be subject to a “real” risk of forfeiture and disposal restrictions).

Further, as section 83A-115(3) is currently drafted, the intent (as noted above) will not be achieved unless there is also a disposal restriction on the right prior to exercise (i.e., a pre-exercise disposal restriction preventing disposal of the right itself). However, even where there is a risk of forfeiture at grant and disposal restrictions on the right / option, this is not sufficient to defer tax without also having (ii) and (iii) above.

The complex interplay of the different subparagraphs will make it difficult to pinpoint the relevant taxing point and explain the rules to employees. As a result, the likelihood of non-compliance (a key issue that the legislation is supposedly intended to overcome) due to confusion may increase.

B. The ESS deferred taxing point for rights may result in adverse tax treatment

Imposing the new “real” risk of forfeiture taxing point on share options will trigger tax at the time options vest; i.e., typically when all performance and service conditions have been satisfied. The vesting point for options may occur some time before the participant is able to exercise the options and sell the underlying shares (e.g., due to general trading restrictions or where the option is not “in the money”). This has several, significant implications:

► The taxing point may arise some time before the employee is able to exercise the option and realise any gain. For example, due to share trading restrictions that apply (in particular to senior employees who for large portions of a financial year will typically be subject to Corporations Law and ASX trading restrictions, such as insider trading rules, and company policies that prevent them from dealing in shares), it may not be possible for an employee to exercise the option for some time after the vesting point. In some cases, such restrictions may only be apparent once the rights vest and it may not be possible or appropriate to formalise restrictions in the
terms of the award when the rights are granted. As a result, the employee may only be able to exercise the option and sell the underlying shares to fund the tax liability at a time when the share price may have moved significantly compared to the share price on which the tax liability is based. Therefore, if the share price has fallen since the option vested, the employee will have been taxed on an amount of income which has not been received, with no ability to claim a refund for the tax overpaid.

In addition, imposing a taxing point at vesting forces employees who can exercise the options (and sell their shares) to immediately dispose of sufficient shares to fund the related tax liability. This is inconsistent with a general shift to encourage long-term share retention by employees.

- The existing valuation rules will give rise to a taxation liability for employees, even where the option is not (and may never be) "in the money". Under the current valuation rules (which we note are to be reviewed), taxable values are imputed for options based on an option’s exercise price and time to expiry, and the company’s prevailing share price. Under the proposals, the valuation rules could, at the time an option vests, impute a taxable value for the option which is significantly higher than the gain an employee could ultimately realise by exercising the option and immediately selling the underlying shares.

For example, an option with an exercise price of $1.00 per share and time to expiry when the option vests of 5 years, would have a taxable value of $0.049 per share under option if the company’s share price was $0.90 at the time of vesting; i.e., tax would be payable at the time of vesting even though share price is lower than the option’s exercise price at the time of vesting (the option is “out of the money”). The option in this case would still have a taxable value even where share price is, say, 30% lower than the company’s share price at the time the option vests (i.e., where the option is significantly out of the money).

Depending on share price performance after the option vests, the employee may never realise any gain from the option – in these circumstances, based on the ED, the employee would be liable to tax when the option vests but would not be entitled to a refund when the option later expires without being exercised (refer comments in section 4 on the tax refund provisions).

Recommended modifications – deferred taxing point for rights / options

A. The provisions are unnecessarily complex and ambiguous

Simplify the provisions: We submit that the provisions on the taxing point for rights should be drafted in a simpler manner to avoid confusion arising as to the deferred taxing point for rights. One approach may be to revert to a “cessation event” listing approach (as per the approach in the current Division 13A legislation), where the default taxing point is exercise of the rights, with deferral only available where there are appropriate post-exercise disposal restrictions on the shares acquired. Note, if plans are appropriately structured under the draft provisions, this would be the likely outcome in any event.

For example, rather than stating the taxing point is the “the earliest time when”, the provision could be reworded to refer to the time “when none of the following apply” and subparagraphs (i) to (iv) could also be reworded appropriately.

B. The ESS deferred taxing point for rights results in potentially adverse tax implications

Different deferred taxing points for rights with market value exercise price versus rights with below-market exercise price: Consider incorporating different taxing points for rights with a market-value exercise price versus rights with a below-market exercise price. For example, zero-exercise priced options could be taxed at vesting (or later where
disposal restrictions apply) and market priced options could be taxed at exercise (in accordance with common worldwide practice).
2.2 **Meaning of “real” risk of forfeiture and “genuine” disposal restrictions**

### 2.2.1 “Real” risk of forfeiture

Although the EM provides examples of conditions that would not constitute “real” risk of forfeiture, there is limited guidance on the conditions that would meet this test.

It is our understanding that the following does not constitute “real” risk of forfeiture:

- Bad leaver provisions (i.e., forfeiture of the ESS interest due to gross misconduct, fraud etc); and
- Other “mere” possibilities (as per wording in the explanatory materials).

It is however, unclear if the following conditions would also constitute a “real” risk of forfeiture:

- A relatively short minimum period of employment (e.g., 3 months);
- Satisfactory performance evaluation of the employee;
- Positive Total Shareholder Return (“TSR”) performance; or
- Shares attaining a set price above market value at the time the ESS is granted.

Further, where there is a “short-term” forfeiture condition, clarification is required as to whether disposal restrictions, once the short-term forfeiture conditions lapse, are sufficient to defer tax.

### Recommended modifications – “real” risk of forfeiture

We submit that the EM provide more detailed guidance on the meaning of “real” risk of forfeiture by way of “real world” examples (e.g., such as those set out above). Such examples could act as documented “safe harbours” and would provide companies operating plans with guidance from a design and employee communication perspective (reducing the need for companies to require formal tax rulings).

### 2.2.2 “Genuine” disposal restrictions

Subsection 83A-115 of the ED uses the term “genuinely restricted”. This concept is not defined in the ED, nor is it discussed in any detail in the EM. The key issue that requires clarity is whether the Government’s intention is that this requirement is similar to the requirement under Division 13A relating to disposal restrictions, which has been addressed in numerous rulings, or whether there is an intention to change existing practice.

### Recommended modifications – “genuine” disposal restrictions

We understand Government’s intention is that the requirement that shares / rights be subject to “genuine” disposal restrictions is similar to the requirement under Division 13A. Accordingly, we submit that this should be clarified in the EM. Specifically, the EM should stipulate that it will be possible to rely on the existing tax rulings that address this issue. The EM should make it clear that the new wording is a terminology change only, and it is not intended to change the law.
2.3 Maximum of $5,000 for salary sacrifice schemes

Overall, subsection 83A(4), which relates to the operation of salary sacrifice schemes, appears to be unnecessarily restrictive and, in some respects, could have the effect of discouraging broad-based employee share ownership by deterring employers from implementing plans which support greater employee equity participation. There are four specific issues which we have identified in this regard:

A. Restricting the amount that can be sacrificed to $5,000: It appears that if the amount sacrificed is greater than $5,000, the whole equity award is taxable and the special salary sacrifice concession does not apply. Restricting the value of shares that can be acquired under a salary sacrifice plan to $5,000 is unnecessarily restrictive, as in our view, a similar outcome can be achieved by simply limiting the amount on which tax can be deferred to the first $5,000 of discount. In the latter case, income tax would still be deferred on the first $5,000, but would be payable upfront on any amount in excess of $5,000.

B. Value of shares employee acquires: The draft provisions are not clear on whether the salary sacrifice amount (i.e., the amount foregone by the individual) needs to equal the value of shares the individual acquires. For example, can $5,000 be sacrificed in return for $1,000 worth of shares? In our opinion, there is no reason for the provisions to disallow this scenario since the maximum amount on which tax can be deferred will be capped at $5,000 per annum, and many varieties of broad-based salary sacrifice schemes are operated, depending on the employer’s particular commercial requirements.

C. The requirement for salary sacrifice schemes to be separate from other plans is restrictive: The ED has introduced a requirement that the $5,000 tax-deferral concession only applies to shares provided under a separate salary sacrifice plan. In our view, this is an unnecessarily restrictive and onerous requirement that does not serve any specific purpose – indeed, the rationale for this requirement is not discussed in the EM.

The requirement for a plan utilising the salary sacrifice concession to be a separate plan to other schemes means that salary sacrifice schemes and tax-exempt schemes cannot operate under the one plan. In our view, this is contrary to the Government’s intention of allowing employees to participate in both types of schemes simultaneously. In addition, the administratively onerous nature of the requirement (i.e., the need for completely separate plan documentation) may deter companies from operating salary sacrifice and tax-exempt schemes side-by-side.

D. Post-tax contributions / matching equity awards: It appears the draft provisions do not allow for employees to make post-tax contributions to acquire shares, or receive additional “matching” equity awards, under plans that utilise the $5,000 salary sacrifice concession.

We note that several listed and unlisted entities in Australia operate salary sacrifice plans which allow for employees to acquire additional shares via a “matching” component. The current provisions would appear to restrict the operation of such plans, limiting the value of the entire equity award to $5,000. In our view, such a limitation is unnecessarily restrictive and will deter companies from operating plans that encourage broad-based employee share ownership.

The EM overlooks salary sacrifice schemes with a matching component: consider for instance, the tax implications of salary sacrifice schemes which provide a matching element (say, for an equivalent number of shares to those salary sacrificed, provided the employee stays employed for 2 years) in the form of rights. For example:

► Are the additional shares (acquired on exercise of the rights) subject to income tax pursuant to the “real” risk of forfeiture test (prescribed in section 83A-115(1))?  

► As the matched component consists of rights, does this mean the salary sacrifice scheme does not satisfy subsections 83A-105(4)(b)(ii) and 83A-105(4)(c)?

► Can the matched component be awarded under the same scheme?

Recommended modifications – $5,000 salary sacrifice schemes

A. Allow salary sacrifice plans to offer more than $5,000k
Limit the application of subsection 83A-105(4) to the first $5,000 of discount each year but allow for more than $5,000 of shares to be acquired (acknowledging that the individual would be subject to tax upfront on the amount in excess of $5,000).

B. Confirm that plans that offer a ‘discount’ to employees can utilise the $5,000 salary sacrifice

- Allow plans to provide flexibility to employers such that the value of shares acquired under a salary sacrifice scheme can exceed the amount sacrificed (subject to the cap of $5,000 per annum on the value of shares for which tax deferral is available).

C. Separate plan requirement is restrictive

- Remove requirement that shares acquired under a salary sacrifice scheme must be provided under a separate plan to other employee equity schemes.

D. Allow for post-tax contributions / matched awards to be delivered via salary sacrifice schemes

- Ensure plans that utilise the $5,000 salary sacrifice concession can also be used to grant other, complementary awards (e.g., post-tax contribution plans or “matching” awards).
2.4 **Income cap of $180,000 for $1,000 tax exemption**

Raising the income cap to $180,000 for the $1,000 tax exemption is a welcome change. There are some technical issues with the definition of the income cap that need to be resolved.

A. **It is our understanding that the income cap for the $1,000 tax exemption relates to the threshold for the highest marginal rate of personal tax.** Accordingly, referencing the highest marginal income tax bracket in the Division 83A provisions would be consistent with Government’s stated intention. In addition, it avoids the need to update the provisions as the relevant tax bracket increases / decreases.

B. **There are inconsistencies in the definition of the income cap in the ED and the EM.** In some cases, the cap is referred to as being “equal to and less than” $180,000; however, in other cases, only employees with adjusted taxable income of “less than” $180,000 can benefit from the $1,000 tax exemption.

<table>
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<tr>
<th><strong>Recommended modifications</strong></th>
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<tr>
<td>A. Specify the tax bracket in the provisions, rather than referencing a specific number</td>
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<tr>
<td>▶ Align the income cap to the highest marginal income tax bracket rather than a specific number.</td>
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<tr>
<td>B. Confirm $1,000 tax exemption available to employees with adjusted taxable income of $180,000 or less</td>
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<tr>
<td>▶ We understand Government’s intention is that the income cap refers to adjusted taxable income of equal to or less than $180,000. The various drafting errors in the ED and EM should be amended to reflect this intention to avoid confusion.</td>
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2.5 **Other aspects to be clarified**

Outlined below are additional key aspects in regard to the new legislation that require clarification.

2.5.1 **Transitional arrangements**

There are several issues that can only be resolved on release of details on the transitional arrangements. It is imperative details are released sooner, rather than later, to ensure Government, employers and employees are able to assess the relevant consequences.

Specific transitional issues that will need to be clarified are:

▶ **Shares / rights granted pre-1 July 2009:** The transitional provisions should stipulate that these remain subject to Division 13A.

▶ **Rulings / ATO IDs issued in relation to Division 13A:** These should continue to be used to assist with interpretation of Division 83A, where appropriate and the transitional provisions should stipulate that they will not need to be “refreshed”.

▶ **Rights granted pre-1 July 2009 that will “crystallise” into Division 13A rights:** Although these rights were not Division 13A rights at the time of grant, they will “crystallise” into Division 13A rights in the future (refer to the following class rulings: CR 2007 / 10 (Sims Group), CR 2006 / 103 (Brambles) and CR 2006 / 101 (BHP Billiton)). These rights should be treated as being subject to Division 13A on the basis that this was the expected outcome at the time the award was granted.

2.5.2 **Interaction with CGT provisions**

One area which requires careful consideration is the interaction between Division 83A and the capital gains tax (CGT) provisions. In our opinion, several modifications are required to ensure harmonious interaction between Division 83A and the CGT provisions. Specifically, it is imperative that certain technical issues are resolved in order to avoid double taxation.
A. **“Interests in trust”:** CGT provisions in relation to “interests in trust” as discussed in New Hope Corporation Class Ruling (CR 2009/20) should be amended such that they cannot apply to “ESS interests” (as defined in subsection 83A-10).

B. **Employee share trusts:** The draft provisions are unclear on the implications as to how the CGT exemption to prevent double taxation would operate where an ESS trust delivers shares to an employee on exercise of an option, but the individual pays tax at vesting.

In addition, it appears the trust rules do not work in respect of loan-based share acquisition plans (for example, in terms of the acquisition time of the shares for CGT purposes), where the ESS interest is acquired at market value but an ESS trust holds the shares until the loan used to acquire the shares is repaid.

It should be made explicitly clear that an ESS trust is just a look-through entity in relation to all ESS interests.

C. **Commencement of CGT holding period:** Under the draft provisions, an ESS interest that qualifies for tax deferral is taken to have been acquired for CGT purposes at the deferred taxing point for the interest. However, for ESS interests that are taxed in the year of acquisition, the CGT acquisition point would be determined under normal CGT principles. This can result in different outcomes depending on whether the ESS interest is held directly or through a trust. For shares granted to employees and held in a trust, the participant would only be entitled to the CGT discount if the shares are held for more than 12 months from the date the shares are released from the trust. This is a different outcome to plans where legal ownership is acquired by participants at the outset but a holding lock applies to prevent trading during a particular period. Essentially, this creates a bias against plans that utilise trusts that seems inconsistent with the acknowledgment that trusts are a legitimate form of plan administration (and should effectively be a “look through” for tax purposes).

Accordingly, where ESS interests are subject to tax at the time of acquisition, the ESS interest should be acquired for CGT purposes on the date the taxing point arises.

D. **CGT event E5:** There should be an amendment to the CGT rules to ensure that CGT event E5 does not apply to distributions of ESS interests from trusts under any circumstances.

E. **Acquisition by trust:** It appears the provision in Division 13A (Section 139C (5)) that ensures that the acquisition of a share or right by an employee share trust is **not** an ESS interest under the relevant provisions, has not been replicated. This provision should be incorporated into Div 83A.

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### 2.5.3 Definitions and clarification

There are a number of definitions that we believe should be included in the draft legislation. In addition, there are a number of provisions that require further clarification. We set out below a list of the issues and our comments.

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<tr>
<td>Forfeiture (and refund rules)</td>
<td></td>
<td>► Clarification is required whether if a share is forfeited after exercise of an ESS option, a refund can still be obtained. The current drafting does not deal with this scenario.</td>
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<tr>
<td>Subsection 83A-310</td>
<td>p 17</td>
<td>► The draft refund provisions discriminate against “underwater options”, where an individual has paid tax at vesting of the options (which, under the current valuation rules could have a taxable value where the share price is lower than the option’s exercise price). This issue should be revisited given it relates to circumstances outside the individual’s</td>
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| Definitions 83A-10 | p 2 – 3 | ➤ No definition of “acquire” is provided (refer to section 139G of ITAA36).  
➤ No definition of “discount” is provided.  
➤ No definition of “permanent employee” is provided. |
| Market value | Various | ➤ Further guidance is required on the meaning of market value. For instance, does market value refer to:  
➤ The actual market value of an asset?  
➤ The market value taking into account restrictions and forfeiture conditions actually imposed on ESS grants to employees?  
➤ The market value, using an accounting-style approach (taking into account, life of the award, performance conditions etc. but not disposal restrictions)? |
| General issue – clarification of references to “scheme” | Various | ➤ References to the ESS “scheme” should be clarified to make it clear that this requirement is to be broadly interpreted such that it refers to both formal plan documentation (i.e. plan rules, trust deed, etc.) and also broader documentation (i.e. offer letters, participant guides, etc.) |
| General definitional issue – ESS interest must be in employer or related company | p 2 – 3 | ➤ Subsection 83A-10 stipulates that the individual has to acquire an ESS interest in their employer or a related company. This may have unintended consequences for award in non-employer companies.  
➤ Previously, such awards would have been “non-qualifying” and would be subject to tax at grant. Under the draft provisions, it appears awards in non-employer companies would be subject to Fringe Benefits Tax (“FBT”). This will create uncertainty and complexity, as well as opportunities for avoidance (as recipients may think their employer is paying FBT, therefore no need to declare).  
➤ This issue is particularly relevant for employment relationships such as joint ventures where the company awarding the ESS interest may not be the “employer entity”, as defined. Clarification is required on whether this is the intended outcome. |
| Relationships similar to employment Subsection 83A-10(2) Subsection 83A-105(3) | p 19 | ➤ It appears tax deferral is only available for employee share schemes in which employees participate. There are three specific issues that need to be considered:  
➤ The provisions only refer to employees - clarification is therefore, required as to whether if non-employees (e.g. consultants) receive awards, the whole scheme does not fall within the new Division 83A. The link to extended employment relationships in 83A-325 is not clear.  
➤ Alternatively, if the “employment relationships” within the categories specified in 83A-235 are intended to be treated as employees for all Division 83A purposes, this means such individuals will be able to potentially defer tax, obtain $1,000 tax exemption, etc. This is more generous than Division 13A and there is a conflict that needs to be resolved.  
➤ Acquisition of ESS interest via an entity – it appears from the draft wording that Division 83A is unlikely to apply where the individual operates through a company, meaning the individual’s company will be taxed at grant (see s 21A, 1936 Act). Clarification is required as to whether this is an intended outcome as it is a change from the previous rules. |
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| Sourcing Rules Subsection 83A-25(2) Subsection 83A-110(2) | P49 | ► Clarification is required on how the amount to be included as “being from a source other than an Australian source to the extent it relates to your employment outside Australia” is to be calculated  
► The previous rules, which were implemented in 2005 following a Government review of international taxation arrangements, were specifically intended to “more closely align the taxation of shares or rights acquired under an employee share schemes with international norms developed by the Organisation for Economic Co-operation and Development (“OECD”). This was achieved by referencing the OECD rules in the EM that accompanies the 2005 legislation.  
► The new provisions do not contain any detailed guidance on sourcing and this may lead to the adoption of differing approaches based on interpretation and will increase compliance costs for affected taxpayers.  
At the least, the EM should contain the sourcing guidance previously set out in the EM for the 2005 legislation.  |
| Integrity rule (previously anti-avoidance provisions in Division 13A of ITAA36) Subsection 83A-30(5)(a)-(c) | p 5 – 6 | ► Clarification is required as to the intention of this provision. This provision as drafted could potentially apply to almost any listed group where there is a holding company whose only activity is to hold all the group subsidiary companies.  
► Clarification is required on whether the provision is drafted correctly (in relation to (b), – delete “not” or subsections should be linked by “ands” not “or”?  
► The subsection does not specify the consequences where the subsection applies – this should be specified. |
| Reporting requirements for employers Division 392 | p 23 – 26 | ► Clarification required as to whether reporting requirements apply to equity awards granted under the old regime but taxed post-1 July.  
► Rules should be clarified to confirm that reporting requirements will not apply to Australian companies with foreign employees not working in Australia at the time of grant / deferred taxing point.  |
| Takeover provisions Subsection 83A-125 | p 12 – 15 | ► The draft provisions do not deal with the 3-year condition in respect of tax-exempt plans (i.e. do not reproduce Section 139CE(3A) ITAA36. |
| General Issue Interaction with Australia’s double tax treaties | p 49 | ► The removal of ITAA 1936 section 139B(1A) (which was introduced in 2005 to align Australia’s treatment of ESS income more closely with that of the OECD) will lead taxpayers with discounts relating to employment to rely on an examination of Australia’s double tax treaties to ascertain if there any grounds for exemption from Australian tax. This will lead to increased compliance costs and this may lead to the adoption of differing approaches based on interpretation  
► The explanatory memorandum should provide more “real world” examples of how Australia’s double taxation agreements will work in practice rather than the vague statement (at 1.252) that “this may be affected by Australia’s double tax treaties. |
| Distributions under ESS | p 35 | ► There is no reason to impose the limitation in subsection Section 208-215(2)(b). All ESS interests should be exempt from these requirements. |

### 2.6 Interaction with Temporary Resident (“TR”) Provisions

The proposals remove the provision which allowed the exclusion of discounts relating to foreign service performed by non-residents  
► The explanatory memorandum (at 1.254) states that the outcome “effectively mirrors the tax treatment of employment income.”
For TRs, this is not the case since the treatment of shares/rights under Division 83A will now differ from the treatment of employment income. For example a cash bonus can be regarded as “non assessable non exempt income” for a TR to the extent it does not represent “remuneration, for employment undertaken, or services provided, while you are a temporary resident” (ITAA 1997 section 768-910(3)(a))

The operation of Div 768 is that the combination of section 768-910(1)(a) and section 768-910(3)(a) means that if a temporary resident receives a bonus after becoming a TR, but which relates to a pre arrival employment period and is therefore foreign source, it is non assessable, non exempt income. This is because such a bonus is not remuneration for services provided while a TR, but rather relates to services provided prior to becoming a temp resident.

On the other hand, the result of the ED seems to be that if a TR holds an ESS interest that is subject to a taxing point during the TR period, the effect of the amendment to section 768-910(3)(d), together with there being no Division 83A equivalent to section 139B(1A), is that the total discount is taxed, even though part of the vesting period occurred when the person was a non resident and therefore that portion cannot be considered to be remuneration for services provided while a TR.

Whether, the removal of section 139B(1A) for normal residents, this means that the treatment of the ESS interest for a TR is inconsistent with the treatment of other remuneration earned by the TR. This cannot be the intended outcome.

**Recommended modification**

A provision should be included, for inbound individuals who meet the criteria to be considered TR, which will exclude from assessable income the portion of the discount that relates to foreign service when a foreign resident. This will restore the consistency of treatment with employment income referred to in the explanatory memorandum.
3. **Other issues**

There are a number of less significant changes that we submit the Government should make to the current draft legislation. We set these out in the table below.

<table>
<thead>
<tr>
<th>Issue</th>
<th>ED Page no.</th>
<th>Comment(s)</th>
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<tbody>
<tr>
<td><strong>Tax-exempt schemes</strong> – potential continuous employment condition Subsection 83A-30</td>
<td>p 4 – 7</td>
<td>► We suggest that the Government consider allowing the inclusion of a continuous employment condition (limited forfeiture) in tax-exempt plan provisions to encourage employees to stay with their employer.</td>
</tr>
</tbody>
</table>
| **Demerger provisions** Subsection 83A-330 | p 19 – 20 | ► Subsection 83A-330 of the draft legislation (which mirrors the existing Division 13A provisions) does not adequately address the interaction between “cessation of employment” and demergers.  
► Inconsistencies can arise for employees in the demerged part of the group who were employed by a different group company at the time of grant of an ESS interest. This could be rectified by only requiring that they were part of the original group at the time of grant. |
| **Foreign Investment Funds (“FIFs”)** Section 530A (2) | p 29 | ► There is no reason why relief from the Foreign Investment Fund rules should be limited to the ESS deferral period. |
| **Division 7A** Section 109NB ITAA36 | p 28 | ► Current drafting is limited such that only shares that meet most of the tax-exemption conditions are excluded from the Division 7A rules. This is excessively restrictive. All loans to acquire ESS interests should be exempt from these requirements. |
4. Comments on specific aspects of Government policy

In our earlier submissions to Treasury and the Senate Economics References Committee in relation to the proposed changes to the taxation of ESS interests, we made a number of suggestions and recommendations in relation to the Government’s policy on employee share schemes.

We highlight the following 2 key issues for consideration:

A. Removal of cessation of employment as a taxing point: We submit that retaining cessation of employment as a taxing point for employee equity awards is inconsistent with the commercial objectives of many schemes, as well as with moves to encourage long-term share ownership by executives, and will ensure that Australia continues to be out of step with its international competitors. In any event, taxing equity awards on cessation of employment will not, in our view, assist with meeting the Government’s stated objective of addressing tax integrity concerns (in our view, the introduction of a reporting requirement for employers regarding employee equity awards is sufficient to meet this objective).

B. Amendment to rules on tax refunds for forfeited equity awards: We recommend modification of the proposed refund provisions so that they apply to tax paid on options (and other rights to acquire shares) that are forfeited (or simply expire), regardless of the reason for the options / rights lapsing.

As noted earlier in relation to the taxable value of options, the existing valuation rules that apply to equity awards would trigger a tax charge when an option vests, even where the option has zero intrinsic gain (i.e., the exercise price is not lower than the prevailing share price).

Under the proposed refund provisions, a taxpayer cannot obtain a refund of tax paid on an option when it lapses if the loss of the option is as a result of a choice made by the individual. In other words, if the taxpayer decides not to exercise the option because the company’s share price remains at a level which is no greater than the option’s exercise price (i.e., the option is never “in the money”), the refund provision would not apply. As a result, an employee could be taxed on the vesting of an option which is never in-the-money and no refund would be available.

In our view, where the taxing point of options is when the options vest (rather than when they are exercised), the refund provision should allow taxpayers to obtain a refund of any tax paid on vesting of the options where the options later lapse without being exercised (regardless of the reason for the options lapsing). We believe that the refund rules should apply to allow a repayment of tax paid on any equity award which is later forfeited without the employee having realised a benefit from the award.

Cross-border employees

We also make the following comments in relation to the implications of the new rules for employees that move internationally. We note that the ED contains provisions that will effectively reverse the reforms to the taxation of employee share schemes which were enacted as recently as 2005 by the New International Tax Arrangements (Foreign-owned Branches and Other Measures) Act 2005. As the new measures were not prefaced in any of the earlier drafts of the legislation or supporting materials we suggest further consultation on the impact of these measures as these have not been debated previously.
As there has been no opportunity to discuss the cross border measures proposed in the ED prior to publication we would also make the following observations:

- The previous measures were introduced (26 June 2005) after a significant review of the relevant tax rules for non-residents. We note that the exemption method used was consistent with OECD principles on taxation of cross border employee equity (see for example the OECD commentary on Article 15 of the Model Treaty). We question the rationale for removing the exemption on the basis ITAA 1936 section 139B(1A) was specifically introduced in 2005 to align Australia’s treatment of ESS income more closely with that of the OECD.

- Adoption of a credit approach in relation to Division 83A income may acceptable to the OECD, but does create unfair compliance difficulties and outcomes to taxpayers that are not warranted by small measures in revenue that would be generated.
  
  i. there could be a long delay between the Australian taxation point and any later overseas taxation required for the FITO (with attendant adverse cash flow implications for the employee);
  
  ii. there may be difficulties in matching the Australian income to the overseas income for FITO purposes since the taxation points may now be different;
  
  iii. there may be significant foreign exchange rate issues resulting from the difference in taxing points; and
  
  iv. the income subject to tax may be different in the overseas location given the potential difference in taxing points.

We question why Australia would wish to move away from the previous regime which was closely aligned with the OECD approach to move to a more complex regime which will significantly increase compliance costs for individuals. The draft measures will also make Australia a much less attractive for highly skilled inbound workers holding equity awards since taxpayers resident at the acquisition or ESS deferred taxing point (as applicable) will prima facie be taxed on the whole discount on awards earned overseas.
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