

**The games: the extension of time to make a s 139E election
[13171] by Gary Fitton, Director, Remuneration Strategies Group, Melbourne**

[Gary is a co-author of Thomson's Australian Financial Planning Handbook, having written the "FBT and financial planning" and "Salary packaging and remuneration strategies" chapters. He has added a substantially expanded section on employee share schemes in the about to be published 2005-06 edition of the Handbook.]

The requirement for taxpayers to make elections in respect of their taxation affairs, and for the Commissioner of Taxation to then have a discretion to extend the time for making that election, has always been an uneasy fit and difficult to administer under a self-assessment taxation regime.

Generally speaking, as a policy, the Department of Treasury and the Tax Office have attempted to avoid imposing discretionary powers on the Commissioner via the taxation legislation where possible. However, in the case of the taxation of employee share benefits under the income tax regime, the governing provisions of Div 13A of the ITAA 1936 have retained the Commissioner's discretion in respect of taxpayer elections concerning the timing of that taxation and access to certain taxation concessions and exemptions.

Section 26AAC

Under the previous employee share plan taxation regime of s 26AAC of the ITAA 1936, sub-ss 26AAC(8A) and (15A) were introduced for share rights (eg options) or shares acquired after 19 September 1985, enabling a taxpayer to elect that the tax deferral provisions of sub-ss 26AAC and (8) and (15) were not to apply in relation to the acquisition of a right or share. The making of the election would ensure the taxpayer would be assessed on any taxable share benefits when the shares were acquired, rather than when the restrictions on disposal of the shares or the forfeiture provisions were lifted. The 19 September 1985 of course is embedded in tax practitioners' brains as the date after which the CGT provisions would apply in Australia.

Basically, by making an election to be assessed on any discounts provided at the time of the acquisition of the shares or rights, those discounts were to be taxed under the CGT provisions at the time of acquisition, rather than being subject to the deferral provisions and later taxed as ordinary income. Where shares or rights (eg options) were issued at the prevailing market price of the shares, or with an equivalent exercise price, there was no taxable discount at the time of acquisition under the provisions of s 26AAC.

These elections were required to have been made before the date of lodgment of income tax returns for the income year in which the shares or rights were acquired or "...within such further period as the Commissioner allows" (refer s 26AAC(8B) and 15(B)).

It is worth noting that there was no requirement under the provisions of s 26AAC for the taxpayer to include such an election in his or her income tax returns. There were also no requirements as to the form of the election or whether the election had to be in writing.

Division 13A

Under the provisions of Div 13A of the ITAA 1936, introduced with effect from 16 December 1995, which supplanted the provisions of s 26AAC as the pre-eminent taxation regime for employee share benefits, the system of making elections by employee taxpayers was carried over and included in the provisions of s 139E.

Under those provisions, a taxpayer could make an election that s 139B(2) applied, which would prevent the tax deferral provisions of s 139B(3) applying to defer the taxation point for qualifying shares or rights until the "cessation time" (ie the earlier of the expiration of 10 years, or termination of employment, or exercise of options, or when the shares cease to be subject to restrictions upon disposal and/or forfeiture conditions).

Section 139E included the additional requirements that the election had to be in writing, and had to be in a "...form approved by the Commissioner...". However, the election did not have to be included in the relevant income tax return for the year of income in which the shares or rights were acquired, and employees were advised by the Tax Office to complete and keep the election for their own records. Refer to the Tax Office booklet *Employee Share Schemes - Answers to Frequently Asked Questions by Employees* on the Tax Office Website - [click here](#)

In situations of employee share plans involving large numbers of employees with various levels of literacy and record keeping skills, it was highly dubious that the relevant elections were made, or if they were made, where and how those elections were retained.

Under many employee share plans, the opportunity for employees to make an election simply was not offered to them. In any event, apart from acquisitions falling under the \$1,000 pa tax exemption conditions, most employees would not be in a position to elect to be subject to income tax on acquisition of the shares or rights, where they received substantial discounted allocations of shares or options, subject to restrictions on disposal or forfeiture conditions.

Of course, unlike the provisions of s 26AAC, the Black & Scholes inspired provisions of ss 139FJ to 139FN of Div 13A (ie minus the volatility factor), now mean that most options issued in respect of employment with a current market value exercise price will have a taxable value when acquired by employees.

Since the introduction of the 50% tax exemption on capital gains from 21 September 1999, which applies to the capital gains made on the disposal of shares or rights to which s 139E elections have been made, many employees have rued the fact that they did not, or could not, make s 139E elections to be taxed on the acquisition of those shares or options.

Some employee taxpayers have requested that the Commissioner exercise his discretion to retroactively "allow further time for the making of the election", to enable them to pay the income tax on the share option benefit when acquired and pay then CGT for the profits made on the disposal of the shares or rights, thereby accessing the 50% exemption applying to taxable capital gains.

Tax Office rulings and decisions

Ruling IT 2609

As far back as 4 October 1990, in IT 2609 para 12, the Tax Office ruled that:

"As a general rule, an extension of time to lodge an extension of time to lodge an election may be granted where, for instance, the original non-lodgment of a notice of [s 26AAC(8A) or s 26AAC(15A)] election was due to a genuine mistake of fact".

ATO ID 2001/402

In this ID, the Tax Office advised that the Commissioner would exercise his discretion under s 139E(2) to allow the taxpayer to make a late election, because the Commissioner:

- was satisfied with the taxpayer's explanation; and
- considers it fair and reasonable in the circumstances to allow the late election.

Although the taxpayer waited 2 years after lodging the relevant income tax return, the taxpayer's grounds of work commitments, young family, and illness were considered sufficient for the Commissioner to exercise his discretion.

ATO ID 2001/607

In this ID, the Tax Office advised that the Commissioner would exercise his discretion based on the taxpayer's grounds of substantial business changes, uncertainty as to the date of acquisition of rights, and the request for extension of time was made shortly after the date of issue of the rights was confirmed by the company.

ATO ID 2002/542

In this ID, the Tax Office advised that the Commissioner would not exercise his discretion under s 139E(2). The taxpayer's grounds for seeking exercise of the discretion were that:

- the options were issued by an overseas company;
- he was advised only of the overseas country's tax treatment of rights;
- he was not advised of the Australian tax treatment; and
- his tax agent was not familiar with the provisions of Div 13A.

The Commissioner ruled that ignorance or failure to understand the operation of Div 13A, either by the taxpayer or his agent, was not an acceptable explanation warranting the grant of an extension.

This is obviously the ruling concerning Mr Isaacs, which was deemed not to be reviewable by the AAT in *AAT Case [2004] AATA 202, Re Isaacs and FCT* (2004) 55 ATR 1044 (see below).

ATO ID 2002/887

In this ID, the Tax Office advised that the Commissioner would not exercise his discretion because the taxpayer was aware of the consequences of not making the elections at the time and because of the period (ie more than 2 years) which had elapsed before making the late election request.

Isaacs case

In the 22 June 2005 decision in *Isaacs v FCT* [2005] FCA 832 (reported at 2005 WTB 27 [1140]), Conti J in the Federal Court ruled that the AAT could not review the Commissioner's decision not to grant an extension of time in which Mr Isaacs could make an election to be assessed on the value of the options, in the year of income in which the options were acquired.

Case background

On 4 March 1998, Mr Isaacs commenced employment as the Managing Director of Cytyc Australia Pty Ltd (Cytyc) a wholly owned subsidiary of a US parent company. As part of his remuneration package, Mr Isaacs was to be granted a significant number of share options. Those share options were to vest at a rate of 25% pa over a period of 4 years. The options were issued as follows:

- on 1 May 1998, Mr Isaacs received 50,000 options from Cytyc;
- on 11 April 2000, Mr Isaacs received an additional 5,000 share options; and
- on 12 March 2001, Mr Isaacs was granted an additional 15,000 options.

It was not until 6 April 2001 that Mr Isaacs became aware of the rights under s 139E to make an election to be taxed at the time of the grant of the options, rather than at the time of exercise, and to be assessed on the 50% discount taxable amount of \$209,802.

Mr Isaacs sought to make the s 139E election within the further period of time allowed by the Commissioner pursuant to s 139E(2).

On 7 February 2002, the Commissioner advised Mr Isaacs in a letter that, as an "international employee", he should have sought advice as to his Australian taxation position in respect of the share options, and that his explanation was "...not a mistake in fact, but a failure to understand the law... and that ignorance or failure to understand the operation of Division 13A... is not an acceptable explanation warranting the grant of an extension".

Section 14ZC of the *Taxation Administration Act 1953* (TAA) states that a person who is dissatisfied with an assessment, determination, notice or decision, may make a taxation objection.

On 20 December 2001, Mr Isaacs objected to the Commissioner's decision. The Commissioner argued that Mr Isaacs' purported objection did not constitute an objection to a relevant "objection decision" within s 14ZY(2) TAA and was nothing more than a request for reconsideration of the Commissioner's s 139E(2) decision. On 7 February 2002, the Commissioner reaffirmed his decision not to allow the extension of time for lodgment of the s 139E election.

Section 14ZZ enables a person to apply to the AAT for a review of the Commissioner's relevant objection decision. On 26 August 2002, Mr Isaacs applied to the AAT for a review of the Commissioner's decision. The AAT ruled that it did not have jurisdiction to hear Mr Isaacs' application for review, as the decision was made as a part of the Commissioner's administrative function, and was not part of the process of assessment.

Mr Isaacs appealed to the Federal Court, and Conti J (at p 39) found that while Div 13A was geared to the annual assessment of taxable income, the discretion conferred on the Commissioner by s 139E(2) to allow further time to make an election is "...logically anterior to the process of assessment of the taxable income of [Mr Isaacs]...[and] did not form part of the income tax assessment process, and accordingly the Tribunal was not empowered and has no jurisdiction to review that decision".

Of course, the decision would continue to be reviewable by the Federal Court under the *Administrative Decisions (Judicial Review) Act 1977*. However, the costs involved with this process would be prohibitive for most employees.

AAT Case 9613

In the earlier 1994 decision in *AAT Case 9613* (1994) 28 ATR 1289, a similar request for the retroactive exercise of the Commissioner's discretion to extend the time a taxpayer could make an

election under s 26AAC(15B) could be made, was considered by the Senior Member Beddoe to be a decision which could be reviewed by the Tribunal. In that case, Mr Beddoe ruled that the extension of time should be granted in accordance with the Commissioner's income tax ruling IT 2662, which provides a global extension of time in which taxation elections could be lodged.

Interestingly, IT 2662 continues to be in operation and in para 4, it reads as follows:

"In every situation where the law authorises the Commissioner to extend the time for making a written election or other written notification, the time for lodgment is to be taken as extended for taxpayers until such time as the Commissioner requires the election or notifications to be made. Exceptions to this are the specific elections or other notifications identified in taxation ruling IT 2624, *Tax Pack*, and other relevant tax office instructions".

In making his decision, Mr Beddoe ruled that, while the Commissioner must make a decision properly, based on the merits of each individual case, IT 2662 did apply, and the taxpayer was entitled to rely on the ruling and that the extension of time was granted accordingly.

While Mr Beddoe's decision was set aside in the Federal Court in *DCT v Coulson* (1995) 30 ATR 261, it was set aside for reasons other than whether the Tribunal could direct that the Commissioner extend the time that an election could be lodged, in respect of the acquisition of shares or rights to shares by an employee.

Conclusion

The presence of taxpayer elections in employee share plan taxing provisions, and the discretion afforded the Commissioner to extend the time for lodgment of elections, is bound to create a situation of ad hoc and subjective decision making that undermines the smooth administration of a taxation system and systemically contradicts the self-assessment process.

The presence of a discretion for the Commissioner to allow late elections has not been helped by arbitrary Tax Office rulings and advices and the current jurisdictional inability of the AAT to review the exercise of the Commissioner's discretion.

The necessity for such elections to be made and recorded by taxpayers under the \$1,000 pa tax exemption provisions is practically unworkable in its current form. It may be better to have employees elect out of the exemption conditions, than have to elect into them.

Perhaps the Government should consider amending the tax exemption process of Div 13A along the lines of the New Zealand employee share plan tax exemption provisions of s DF7 of the NZ *Income Tax Act 1994* - which do not require the eligible taxpayer to make any election.