

## THOMSON ATP WEEKLY TAX BULLETIN

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### Taxation of employee share options – what is in store? - by Gary Fitton, Director, Remuneration Strategies Group

On 1 May 2008, the Treasurer stated that the Government would close a 'loophole' which allows employees to pay the tax upfront on the acquisition of options on a lower value. The Treasurer's comments appear to have been made as a "doorstopper" in the context of delivering family friendly tax reform in the Budget and were rather thin on detail: see 2008 WTB 18 [639].

#### **Backdated election**

Some reports of the Treasurer's statement focused on employees acquiring options and then some years later, making an election under s 139E of the ITAA 1936 to be taxed upfront on that acquisition. Apparently, that election had been backdated to the income tax year of acquisition of the options.

However, from our reading (and our experience) of s 139E(2), the late election can only be made, "...within such further time as the Commissioner allows".

It is our experience as consultants in this area that the ATO has been very reluctant to allow further time for the making of s 139E elections - especially since 1999 and the introduction of the Ralph Committee's recommended 50% exemption of capital gains on assets held for the requisite minimum holding period of 12 months.

#### **Why make an election?**

Making the s 139E election will make acquisition of the options assessable to the employee upfront, on the taxable value determined under the tabulated provisions of s 139FM of Div 13A.

The tax advantage of making the election to pay income tax upfront on the acquisition of the options is that the tax on the subsequent exercise of the options and acquisition of the shares is deferred, until the shares are sold and the profits on those sales of shares are taxed as a discount capital gains. This is subject to a maximum effective individual marginal tax rate of 23.25% (ie assuming the shares have been held for at least 12 months).

#### **Example**

For example, if a company, say CobCo Ltd, issues an option to an employee with a 5-year life and a strike price at the market value share price, this will create an income taxable value of 11.6% of the share price for the employee (eg a CobCo Ltd share price of \$2 creates a taxable value of 23.2 cents per option). If the employee were to be subject to the current maximum marginal income tax rate of 46.5%, he or she would pay income tax of 10.788 cents per option.

The employee would also establish the first element of the CGT cost base, which would be topped up by the payment of the exercise price for the share. If the CobCo Ltd share value grew to, say, \$5 at year 5, and the employee then sold the share, the employee would pay additional CGT of 64.356 cents as a discount capital gain - resulting in total tax paid on the option acquisition and share sale of 75.144 cents.

Furthermore, the employee making the election and paying income tax upfront is taxable, subsequently, *only* upon the occasion of the sale of the option or share. Unlike, the deferral provision of Div 13A, there are no earlier intervening taxation triggers (see later under "No election").

### **Election problems**

The problem for most employees, when deciding whether or not to make a s 139E election to be taxed upfront, is how to fund:

- the upfront income tax liability; and
- the payment of the option exercise price.

These obstacles have acted as a general deterrent to employees making a s 139E election. Therefore, most employees would not be in a position to make the election to be taxed upfront.

### **No election**

If the employee in the above example had not made the s 139E election, and the option was a qualifying right under the provisions of s 139CD, he or she would not pay tax upfront, but would fall under the tax deferral provisions until the occasion of a 'cessation time'. If the employee exercised the option and sold the share in CobCo Ltd (ie the cessation time) under the same circumstances as outlined above, he or she would pay a total income tax amount of \$1.395.

By not making the election, the employee is also subject to other alternative intervening taxation (ie cessation) events, apart from sale of the option or share, being the earliest of:

- the exercise of the option;
- the termination of employment; or
- the expiration of 10 years from acquisition of the option.

Therefore, the employee is in a much better overall position if he or she can make the s 139E election.

## **Option value**

The tabulated valuation formula encapsulated in s 139FM to determine the upfront taxable value of the option is based on generally accepted Black and Scholes option valuation principles, but with a slight concession built in by way of the absence of a so-called "volatility factor" - which is a subjective measure that tracks anticipated growth in the share values.

The accounting for valuation of options comes under the heading of Share Based Payments, which are encapsulated within accounting standard AASB 2, published by the Australian Accounting Standards Board, with general effect from 1 January 2005. AASB 2 was based directly on the internationally accepted IASB 2, released by the London Based, International Accounting Standards Board, headed by its Chairman, Sir David Tweedie.

Under the provisions of AASB 2, the relevant accounting expensing event for the company is the issue of the options spread over any pending vesting conditions. Consequently, in the earlier example, the option issued to the employee by CobCo Ltd would need to be accounted for as a Share Based Payment expense in the Profit and Loss Account, and valued in the accounting year in which the options were allocated, spread over the terms of any vesting conditions set as terms of issue.

## **Deductibility of share options**

One should keep in mind that, although the company must expense the issue of the options in its annual profit and loss accounts, the mere issue of options to employees is not deductible to the issuing company. The former Treasurer, the Hon Peter Costello issued a Press Release (No 26 of 30 April 2004) stating that the then Government would not amend the income tax laws to facilitate deductibility to a company (eg CobCo Ltd) for the issue of options to employees.

However, CobCo Ltd would obtain an income tax deduction for irretrievable contributions it makes to a Plan Trustee to acquire options, which are then allocated to employees (refer ATO Interpretative Decision ATO ID 2002/1074).

## **Division 13A**

The methodology for determining employee option taxable values was first introduced into the provisions of the ITAA 1936 by the implementation of the provisions of Div 13A by the then Federal Labor Government in 1995.

## **Section 26AAC**

Prior to that, the previous provisions of s 26AAC of the ITAA 1936 had no bases for valuing option acquisitions for taxation purposes and were usually acquired tax-free (ie even when employees elected to be taxed upfront under the provisions of s 26AAC(8A)).

## **Cases**

The election to be taxed upfront is actually in accordance with the landmark judicial decisions on the taxing of employee share options of the UK House of Lords in *Abbott v Philbin* [1961] A.C.

352 and the later Australian decision in *Donaldson's* case [1974] 1 NSWLR 627. In both those cases, the courts ruled that the sole employment-related income taxing event for the employee was the acquisition of the options - not the exercise of the options.

## **Conclusion**

One must have concerns that the hyperbole and hysteria concerning executive remuneration arrangements may have overcome the logic of a fair and comprehensive system for taxing employee share options. If employees pay for an asset or pay the income tax on that asset benefit upfront, logically, any future gain should be capital gain - and taxed as such.

Share Options have become a vital part of attracting, retaining and motivating employees - especially for start-up companies in the finance, mining, computer and research and development industries. Research by Babenko, Lemmon and Tserlukevich (2008) has demonstrated that employee option grants have enabled businesses to increase investment in positive net present value projects by a factor of \$0.38 for each dollar of proceeds received from the exercise of employee share options [see Babenko, Ilona, Lemmon, Michael L and Tserlukevich, Yuri, " *Employee Stock Options, Financing Constraints, and Real Investment: Theory and Evidence*", University of British Columbia, UBC Winter Finance Conference 2008 - Available at SSRN: <http://ssrn.com/abstract=1101292>].

It would be unfortunate for the Australian economy as a whole for any tax changes to act as a deterrent to future employee option allocations, as a key part of the retention and development of organisational human capital assets, and the freeing up of vital current and future capital project funding opportunities.

In any event, it will be interesting to see if more details are revealed in the forthcoming Federal Budget on what the Treasurer has in mind for the taxing of employee share options.

*[Gary Fitton is author of the "Salary packaging and remuneration strategies" and "FBT and financial planning" chapters of Thomson's Australian Financial Planning Handbook.]*