

## Working For Your Share

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Whether you've got the most basic employee share scheme or a large part of your remuneration package is tied up in shares and options, it's vital you know how they work.

Getting them wrong can land you with big tax bills that could have been avoided.

Planning is everything, say the specialists. With their help, Smart Money has devised a 10-point strategy to help you get the most from your employee share acquisition scheme (Esas).

In many cases the biggest decision is whether to pay tax upfront or defer it.

"It's important to seek advice in advance as there are distinct differences," says Colin Lewis, head of technical services at ipac Securities.

If you opt for the former, it's initially in the form of Esas tax at your marginal tax rate - basically income tax - on the value of the share benefit at that time, followed by capital gains tax on any profit after that.

And you will benefit from paying CGT on only 50 per cent of the profit if you've held the shares for more than 12 months.

If, on the other hand, you defer paying tax - which you can do for up to 10 years - it'll be income tax with CGT later once you sell the shares (unless you sell within 30 days).

Another important point, says Paul Ellis of Ernst & Young, is to make sure you're investing in your company because you think it's a sound investment.

### 1. What's the nature of the plan?

"There are so many different types of equity and quasi-equity plans around," says Sally Morton, tax partner with Deloitte. Depending on the plan, the tax treatment will be different - for example, when the taxing point will be and how the overall gain is measured. (See accompanying article, "The five most common share plans".)

### 2. Is the granting of the shares a taxing point?

The rules can be different for each individual, says Deloitte tax principal Monica Dolinsky, and depend on whether the award to you is "qualifying" under Australian Tax Office rules. If it is not, you'll have to pay Esas tax at your marginal rate at the date of the award (and CGT when selling). If it is a qualifying award, you have a choice: paying upfront or deferring tax. If the latter is your choice, you'll have to pay tax at "cessation time" - generally the earliest of when there are no restrictions on sale or forfeiture conditions attached to the shares; when you sell the shares; when employment ceases; or 10 years from the date of acquiring the shares.

### 3. Why choose to pay tax upfront?

It's worth paying upfront in some cases, say Dolinsky and Morton - particularly where you expect a large share price jump. That's because you'd be paying CGT on only half the gain (if you hold for more than 12 months), whereas if you deferred paying tax the later value of the shares would be subject to your marginal tax rate.

Colin Lewis of ipac Securities says if you intend holding the shares for more than 12 months, it's worth taking the upfront option - because of the CGT discount.

The one exception, he says, is when you salary-sacrifice - that is, receive pre-tax shares rather than cash salary. "The intention is to defer tax otherwise you're defeating the purpose," he says.

It can also be worth paying tax upfront with options, Morton says, where the value [at grant] is minimal. "The risk is that you're just paying tax on a piece of paper as you don't yet have any shares," she says. And it's a funding issue because you have to come up with the tax money before you've exercised the options or sold the shares.

In the case of options, if you pay upfront and you never exercise them because they become "underwater" - that is, drop below the value where you could exercise them - you can get a refund. With shares, though, if the share price drops it's just a capital loss which can be set against a capital gain. But, says Lewis, you can carry forward a capital loss.

#### **4. Can there be a conflict between schemes?**

Yes, says ipac Securities' Lewis. If you have the \$1000 exemption plan (see "Five most common plans" for rules) and you're salary-sacrificing bigger amounts into a broader share plan, they will be at odds with each other. To take advantage of the \$1000 scheme you've got to elect for upfront tax. The conflict comes, he says, because when you elect to pay upfront on the one plan, it also applies to all the other plans you have for the year.

So you won't be able to defer tax on the bigger scheme - which is the whole point of salary-sacrificing.

#### **5. What does vesting mean?**

It's when you have an absolute entitlement to receive the shares with no more conditions attached. For an option or restricted share, says Morton, you don't have a full right to that award until certain conditions of time or performance measures are satisfied.

#### **6. How is the tax paid?**

You are responsible for paying the tax - it is never withheld by your employer. This is an important point because in some cases, say Morton and Dolinsky, "the employee might naively believe tax is withheld at source and it's not".

#### **7. What's the impact of reporting share plan gains in your tax return?**

If income from your employee share plan is more than \$2000 in one year, says Dolinsky, the next year you will fall within the PAYG instalment tax system - in addition to PAYG withholding where your employer withholds tax. This means that at the beginning of the next year you will have to estimate your "instalment income" (which includes income from share plans, investment property and bank interest).

You can vary those estimates up or down, but if your estimate is less than 85 per cent of what you actually get you will pay penalty tax. So if one year you put in a zero estimate because you've decided you won't exercise any options or sell any shares, you'll be up for those penalties if you change your mind, Dolinsky says.

#### **8. Once the shares are sold, what happens?**

If you paid tax upfront, you'll have to pay CGT on sale. If you've deferred paying tax and have sold within 30 days of the taxing point, no CGT will be payable. If you've paid your deferred tax and sell months or years later, you'll have to pay CGT. If you hold the shares for more than a year, only half the gain will be subject to CGT.

## 9. What happens if you borrow funds to buy the shares?

Where the company lends you money to buy the shares, the loan is generally required to be repaid once the shares are sold, say Morton and Dolinsky. You get an interest deduction for the borrowings. There are also zero-interest loans, says Gary Fitton, director of Remuneration Strategies Group in Melbourne. These fall under the "otherwise deductible" rule - if the interest would have been 100 per cent tax-deductible in your hands and your employer pays the interest on your behalf, there is no fringe benefits tax (FBT). Either way, if you have a geared plan, says Fitton, make sure you are protected if the shares plunge. (See accompanying article, "Market ups and downs".)

## 10. When you terminate your employment, what's the impact?

If you didn't pay tax upfront, this will trigger payment of Esas tax. Where options are concerned, if the executive is allowed to keep them, the leaving point will trigger tax even if the options haven't been exercised. The same holds true with restricted shares.

"I've seen companies where executives have not been allowed to sell the shares after termination - they've still got to run their period," says Morton. "They've got an absolute entitlement but there's still some time before they can sell the shares. They're taxed on the amount before they can realise them."

The other danger is that the share market can change. "If there's a freeze on selling shares and the price drops significantly, they could realise a much lower gain than the amount on which they'd paid tax," Morton says.

### CASE STUDY 1: THE \$1000 EXEMPTION PLAN

On July 1, 2002, James acquired 250 shares in his employer, Bugle Limited, for which he paid nothing. The market value of the shares was \$4 each.

Total Esas tax payable in the 2002/03 income tax year (assuming the highest marginal tax rate) =  $(250 \times \$4 - \$1000) = \text{nil}$  On July 1, 2012, James sells the shares for \$7 each. As he has held the shares for more than 12 months from the "cessation time", the 50 per cent CGT discount applies. The cost base is \$4 per share (ie, there is no reduction because of the \$1000 discount)

CGT payable:  $250 \times (\$7 - \$4) \times 0.5 \times 48.5\% = \$181.88$  Source: *IPAC Securities*

### CASE STUDY 2: SALARY SACRIFICING

Maggie plans to allocate \$10,000 from pre-tax salary to purchase shares in her employer, Bloggs Limited. The price of the shares on July 1, 2004, is \$10. Her options are:

To pay tax of 48.5 per cent and purchase shares with the net \$5150, buying 515 shares;

or

To buy shares with pre-tax salary, so she can purchase 1000 shares.

If she sells the shares on July 1, 2009 when the price has increased to \$15 she will net the following amounts for the two scenarios:

Shares from post-tax salary: Gross proceeds:  $515 \times \$15 = \$7725$  CGT payable:  $515 \times (\$15 - \$10) \times 0.5 \times 48.5\% = \$624.44$  Net proceeds: \$7100.56  
Shares from pre-tax salary: Gross proceeds:  $1000 \times \$15 = \$15,000$  Esas tax payable:  $1000 \times \$15 \times 48.5\% = \$7275$  Net proceeds: \$7725 So she's better off salary-sacrificing by \$624.44.

Source: *IPAC Securities*

### CASE STUDY 3: OPTIONS

Michelle is granted 1000 options to buy shares in Goanna Limited on July 1, 2004. The exercise price of the rights is \$10 each, compared with a market value of \$10. The earliest time she can exercise the options is July 1, 2009, the last date is July 1, 2014. Her marginal tax rate is 48.5 per cent.

If Michelle elects upfront taxation, the tax payable with her 2004/5 income tax assessment will be the greater of:

$$1000 \times \$10 \times 18.4\% \times 48.5\% = \$892.40;$$

or  $1000 \times (\$10 - \$10) \times 48.5\% = \$0$  (\*the deemed value of a right, where the exercise price is equal to the market value and there is the maximum period of 10 years during which the option can be exercised, is 18.4 per cent of the market value of the share)

On July 1, 2014 Michelle sells the shares for \$25 each. As she has held them for more than 12 months, the 50 per cent CGT discount applies.

Her cost base is \$11.84 (\$10 + \$1.84) per share CGT payable:  $1000 \times (\$25 - \$11.84) \times 0.5 \times 48.5\% = \$3191.30$  Her total taxation under the upfront method:  $\$892.40 + \$3191.30 = \$4083.70$ .

But if Michelle does not elect to be taxed upfront, and exercises the options on July 1, 2009, when the market value of Goanna shares is \$18, the tax payable with her 2009/10 income tax assessment is:

$$1000 \times (\$18 - \$10) \times 48.5\% = \$3880.$$

She later sells the shares for \$25 each on July 1, 2014. As she has held them for more than 12 months after "cessation time" (the point at which she had to pay the tax she'd deferred), the 50 per cent CGT discount applies.

Her cost base for CGT is \$18 per share.

CGT payable:  $1000 \times (\$25 - \$18) \times 0.5 \times 48.5\% = \$1697.50$  Her total taxation:  $\$3880 + \$1697.50 = \$5577.50$  In this example less tax is payable if upfront taxation is selected, which is due to the growth in the share price. But it does not take into account the time value of money.

*Source: IPAC Securities*