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Why employee share schemes need to keep one eye on tax

BUSINESS

Designed appropriately, an ESS can help align the interests of the employer and staff.

By Jeremy Makowski•03 March 2023•7 minute read

An employee shares scheme (ESS) can be a useful tool in aligning the interests of employees and employers while also enabling newer and smaller businesses, including start-ups, to compete with larger and better resourced rivals for top talent.

By offering shares or rights that vest on the completion of certain criteria – such as length of time served and/or attainment of performance targets – desirable behaviours can be encouraged and employees can be appropriately and effectively incentivised without an upfront cash cost to the business.

However, when implementing an ESS or similar scheme it is important to consider the taxation ramifications for the participating employees. “Gifting” employees an unfunded tax liability will undermine the purpose behind the ESS and will not assist with attracting and retaining talent.

Tax ramifications

The default tax position for an ESS is that the discount offered to employees on their acquisition of shares or rights will be taxed upfront in the same way as a bonus.

However, there are opportunities within the tax legislation[1] to design an ESS to fall within an available concession so that there will be no upfront taxation liability for participants.

For example, the “start-up” concession, among other benefits, does not tax employees on either the grant, vesting or exercise of the ESS interest. Instead, participants are only taxed upon an ultimate disposal under the (discountable[2]) CGT regime.

The eligibility criteria for the start-up concession includes that the:

- company is an Australian resident and does not have more than $50 million of aggregated turnover;
- equity is not listed;
- company has not been incorporated for more than 10 years and the ESS is in respect of ordinary shares;
- maximum discount offered to employees is 15 per cent;

- exercise price for options is at least equal to the market value;
- employee does not have more than a 10 per cent shareholding and voting interest; and
- minimum holding period and broad availability conditions are met.

If the start-up concession is not available because, for example, the company was incorporated more than 10 years ago, it may still be possible to defer the taxation point via another concession.

For example,[3] in addition to other general criteria,[4] employees participating in schemes where there is a real risk (more than a mere possibility) that they will forfeit their ESS interest (other than by disposal, exercising it, or letting it lapse) may be eligible to have the tax deferred. Same too but only in the case of rights, where, among other criteria, the scheme imposes a genuine restriction on sale.

If such schemes are structured appropriately by reference to the eligibility criteria (which has not been exhaustively set out here), then eligible and participating employees can defer the tax until the earlier of:[5]

- when there is no longer any real risk of forfeiture (and, if applicable, in the case of rights, broadly, there is no longer a genuine restriction on sale); or
- 15 years.

Curiously, in the case of shares, to qualify for the deferral an ESS will need to be made available to at least 75 per cent of Australian permanent resident employees, whereas no such requirement exists for rights.

While founders may want to participate to minimise dilution, given they will typically own more than 10 per cent, they will not be eligible for the start-up or the other deferred taxation concessions and so if upfront tax is not palatable, other options may need to be explored.

Loan funded share plans

A loan funded share plan (LFSP) may appeal to employees as there is no upfront contribution and there will be no upfront tax. This is because under a common LFSP, the employees acquire the shares at market value but the employer provides the funding via a loan, typically interest free. The loan can be repaid by dividends and/or upon the employee selling their shares.

Given the employee acquires the shares at market value, there is no discount component that is taxable and so any tax is solely governed by the CGT regime (when there should be cash to fund the tax liability). Given any error in calculating the market value of the shares will undermine the intended operation of the LFSP, in some instances, it may be advisable to approach the ATO to sign-off the market value.

While an interest-free loan could trigger FBT, the “otherwise deductible rule” may apply to reduce it to nil but only if there is a reasonable expectation that the shares will generate (assessable) dividends. The reasonable expectation may be more difficult to establish in the case of an early start-up compared to a more established business with a track record of generating profits and paying dividends.

Additionally, given a LFSP relies on an interest-free loan from the company, Division 7A may reduce its attractiveness to existing shareholders, such as founders, unless the company does not have a distributable surplus. The lack of a distributable surplus may also impact the reasonable expectation of future dividends when assessing whether the otherwise deductible rule applies for FBT, but depending on the circumstances, it may still be possible for that rule to apply despite the lack of a distributable surplus.

Take aways

As interest rates are rising and cash flow is tight, an ESS may remain an important tool for employers to attract and retain talent. Yet employees are also feeling the tougher economic environment and so an upfront tax liability may be a deal-breaker.

Accordingly, it is important that any ESS is designed in a way that achieves its purposes. It may even make sense to offer multiple schemes that are tailored to the needs of each class of employee and the overall company's business objectives.

Complex issues such as valuing the company will need to be appropriately managed. In some instances, it may be advisable to obtain certainty on specific risks by approaching the ATO prior to implementation.

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[1] See Division 83A of the *Income Tax assessment Act 1997*.

[2] The 50% discount will apply if the 12-month holding period is met, which should be the case given the minimum holding period required to be eligible for the start-up concession.

[3] Some examples are provided here but it is by no means exhaustive and there are others deferral schemes too, such as those offered under an eligible salary sacrifice arrangement.

[4] Such as that the ESS interest relates to ordinary shares, the employee has less than a 10% interest, and the satisfaction of integrity rules relating to share trading and investment companies etc. It is important to consider all the eligibility criteria carefully as this article has not exhaustively set out all requirements.

[5] Note the specific requirements must be considered carefully and for example, in the case of rights, the timing will depend on whether the rights have been exercised or not etc.