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Employee Share Schemes

There are two employee share scheme examples below. The first looks at the tax alternatives associated with shares and the second addresses the issue as it applies to options.

Example - Shares

In November 2008, you were granted 10,000 shares in your employer as part of an Employee Share Scheme. The price of the shares upon issue is \$10.00 per share. You receive this benefit at no cost, meaning that you have received a benefit to the value of \$100,000. The shares are restricted until November 2013, when they will vest in your name.

If you do nothing, you will automatically be deemed to defer the tax until a later date (the cessation time). In this case, the cessation time is expected to occur at the time of vesting – i.e. November 2013.

An alternative you have is to pay the tax upfront. This can be done by making an election in your 2008/09 tax return.

Event 1 – Issue

The situation upon issue (under either alternative) would be as follows:

Receipt - Nov 2008	Do nothing - no Election	Elect to pay tax upfront
Tax Market Value	\$100,000	\$100,000
Assessable Income	\$0	\$100,000
Tax Rate	46.5%	46.5%
Tax Payable	\$0	-\$46,500
Cost Base	\$0	\$100,000

The “Tax Market Value” is equivalent to the discount you receive from your employer as a result of being issued with the securities. It is the value at the date of issue¹.

¹ Your employer should also be able to provide you with this information upon request.

If you choose to pay tax upfront, the discount is added to your assessable income to determine your tax for the year. Assuming you are on the top marginal tax rate, this would result in a tax liability of \$46,500.

In essence, it's the same as receiving additional gross salary of \$100,000 and paying the tax via your tax return (rather than via the PAYG system).

A consequence of paying the tax upfront is that you create a cost base for the securities (equivalent to the Tax Market Value). Any future growth on the value of the shares will be treated as a capital gain and subject to the capital gains tax regime.

No tax outflow occurs if you do not make the election. From this short term perspective, the decision to "do nothing" is more appealing.

Event 2 – Cessation

The next event occurs when the shares vest. Let's assume that the shares have recovered from the lows of November 2008 and are trading at \$18.00 per share at the time of vesting (i.e. November 2013).

Vesting - Nov 2013	Do nothing - no Election	Elect to pay tax upfront
Tax Market Value	\$180,000	\$180,000
Assessable Income	\$180,000	\$0
Tax Rate	46.5%	23.25%
Tax Payable	-\$83,700	\$0
Cost Base	\$180,000	\$100,000
Value of Shares	\$180,000	\$180,000

This is the trigger for taxing the original employee benefits under the deferral option. The shares are valued at the time of vesting and this is treated as assessable income in your 2013/14 tax return. This would generate a tax liability of \$83,700 (assuming you are on the top marginal tax rate).

These shares are now treated as having been purchased at that date for a cost of \$180,000. Any future gain on the shares will be taxed under the capital gains tax regime.

Many people fail to realise that the act of vesting is a taxing point. They may not have the \$83,700 available to pay the additional tax and may be forced to sell some of the shares to fund this liability.

Importantly, if you had elected to pay tax upfront, no tax liability would be created when the shares vest. The only future tax liability under this option is when you sell the shares.

From this perspective, opting to pay tax upfront provides more tax management flexibility. It also links the timing of the tax liability with the cash inflow from any sale.

You will note that at this point you would have paid more tax under the option to defer (i.e. \$83,700) than you would have under the option to pay tax upfront (\$46,500). You have, however, created a higher cost base.

Event 3 – Share Sale

In December 2014, you decide to sell the shares at \$20.00 per share.

Sale - Dec 2014	Do nothing - no Election	Elect to pay tax upfront
Sale Proceeds	\$200,000	\$200,000
Cost Base	(\$180,000)	(\$100,000)
Assessable Income	\$20,000	\$100,000
Tax Rate	23.25%	23.25%
Tax Payable	-\$4,650	-\$23,250

The tax rate in each case represents the discounted capital gains tax rate. However, had you sold your shares within 12 months of the vesting date you would not be eligible for this discounted tax rate.

Summary

Tax Summary	Do nothing - no Election	Elect to pay tax upfront
At Issue	\$0	\$46,500
At Cessation Time	\$83,700	\$0
At Sale	\$4,650	\$23,250
TOTAL TAX PAYABLE	\$88,350	\$69,750
EFFECTIVE TAX RATE	44.2%	34.9%

In this case, the decision to elect to pay tax upfront has been rewarded. This is largely driven by the strong capital growth of the shares over the period.

Example - Options

In November 2008, you were granted 10,000 options to purchase shares in your employer at an exercise price of \$10.00 per share. These were issued under an Employee Share Scheme for no cost. The options mature in November 2013 and have a current value of \$12,000.

If you do nothing, you will automatically be deemed to defer the tax until a later date (the cessation time). In this case, the cessation time is expected to occur at the time you exercise the options. We assume this will be at maturity in November 2013.

An alternative you have is to pay the tax upfront. This can be done by making an election in your 2008/09 tax return.

Event 1 – Issue

The situation upon issue (under each alternative) would be as follows:

Receipt - Nov 2008	Do nothing - no Election	Elect to pay tax upfront
Tax Market Value	\$12,000	\$12,000
Assessable Income	\$0	\$12,000
Tax Rate	46.5%	46.5%
Tax Payable	\$0	-\$5,580
Cost Base	\$0	\$12,000

The “Tax Market Value” is equivalent to the discount you receive from your employer as a result of being issued with the securities. It is the value at the date of issue².

If you choose to pay tax upfront, the discount is added to your assessable income to determine your tax for the year. Assuming you are on the top marginal tax rate, this would result in a tax liability of \$5,580.

A consequence of paying the tax upfront is that you create a cost base for the securities (equivalent to the Tax Market Value). Any future growth on the value of the options will be treated as a capital gain and subject to the capital gains tax regime.

No tax outflow occurs if you do not make the election. From this short term perspective, the decision to “do nothing” is more appealing.

Event 2 – Cessation

The next event occurs when the options are exercised (assumed at maturity). Let’s assume that the shares have recovered from the lows of November 2008 and are trading at \$18.00 per share at the time of exercise in November 2013. The options are therefore in the money by \$8.00 per share.

Exercise - Nov 2013	Do nothing - no Election	Elect to pay tax upfront
Value of Shares	\$180,000	\$180,000
Exercise Cost	(\$100,000)	(\$100,000)
Tax Market Value	\$80,000	\$80,000
Assessable Income	\$80,000	\$0
Tax Rate	46.5%	23.25%
Tax Payable	-\$37,200	\$0
Cost Base	\$180,000	\$112,000
Value of Shares	\$180,000	\$180,000

² This is determined by a formula used by the Australian Tax Office. Your employer should also be able to provide you with this information upon request.

Exercising the options is a trigger for taxing the original employee benefits under the deferral option. The benefit is valued at the difference between the market value of the shares at the time of exercise and the exercise cost. This is treated as assessable income in your 2013/14 tax return. It would generate a tax liability of \$37,200 (assuming you are on the top marginal tax rate).

These shares are now treated as having been purchased at that date for a cost of \$180,000, (being the sum of the exercise cost and the tax market value). Any future gain on the shares will be taxed under the capital gains tax regime.

Many people fail to plan for the outflow of both the exercise obligation and the tax and consequently have to sell some of the shares to fund these obligations. A considerable amount of pre-planning is required to effectively manage the cash flow obligations associated with employee shares and options.

Importantly, if you had elected to pay tax upfront, no tax liability is created when exercising the options. The only future tax liability is when you sell the shares.

One downside of electing to pay tax upfront is the risk of the options expiring worthless. In this case, you would have paid tax of \$5,580 and created a capital loss of \$12,000.

Following the exercise of the options, you would have paid more tax under the option to defer (i.e. \$37,200) than you would have under the option to pay tax upfront (\$5,580). You have, however, created a higher cost base.

Event 3 – Share Sale

In December 2014, you decide to sell the shares at \$20.00 per share.

Sale - Dec 2014	Do nothing - no Election	Elect to pay tax upfront
Sale Proceeds	\$200,000	\$200,000
Cost Base	(\$180,000)	(\$112,000)
Assessable Income	\$20,000	\$88,000
Tax Rate	23.25%	23.25%
Tax Payable	-\$4,650	-\$20,460
Sale Proceeds	\$200,000	\$200,000

The tax rate in each case represents the discounted capital gains tax rate. However, had you sold your shares within 12 months of the vesting date you would not be eligible for this discounted rate.

Summary

Tax Summary	Do nothing - no Election	Elect to pay tax upfront
At Issue	\$0	\$5,580
At Cessation Time	\$37,200	\$0
At Sale	\$4,650	\$20,460
TOTAL TAX PAYABLE	\$41,850	\$26,040
EFFECTIVE TAX RATE	41.9%	26.0%

In this case, the decision to elect to pay tax upfront has been rewarded. This is largely driven by the strong capital growth of the shares over the period.

General Advice Warning

The material contained in this article is for general purposes only and should not be used as a substitute for personal financial advice. This information is prepared without taking into account your specific objectives, financial situation or needs. No person should act or refrain from acting solely on the basis of this material.

Before making a financial planning or investment decision, you should consider if it is appropriate for your circumstances. You should read and understand any relevant Product Disclosure Statements or any other associated documentation relevant to your individual situation.

As future corporate, legislative and economic factors cannot be predicted on a long term basis, this information should be regarded as a guide only and no guarantee is expressed or implied in relation to any income, growth or asset projections that are shown above.

The above information does not consider all taxation issues associated with employee share schemes. It is provided for illustrative purposes only. You should seek specialist advice with regard to taxation.

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