Back to the future and beyond

Australia’s industry innovation and competitiveness agenda and the proposed new rules for taxing benefits under employee share schemes

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Abstract

Australia’s rules for taxing benefits under employee share schemes in Div 83A of the Income Tax Assessment Act 1997 have been subject to much criticism, particularly by start-up companies and the venture capital industry. The Government under its new Industry Innovation and Competitiveness Agenda proposes to reform the rules for taxing such benefits from 1 July 2015. This article examines how the current rules in Div 83A operate and analyses how the Government’s proposed reforms are intended to change the way in which benefits under ESSs will be taxed. The article compares the policy rationale that underpins both the current and proposed regimes and focuses on how the current and proposed rules affect start-up companies.

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This paper was accepted for publication on 12 February 2015.
1. Introduction

One of the common ways that companies around the world often remunerate and incentivise their employees is by issuing them with shares, or options to acquire shares, under their 'employee share ownership plans' (ESOPs).\(^1\) Many countries, including Australia, the United States, the United Kingdom, Canada and Singapore, have special regimes for regulating and taxing benefits received under these plans.\(^2\) The particular schemes developed in these jurisdictions each have their own qualifying criteria and are usually supported by a range of specific tax concessions to encourage participation. While the names of the schemes may differ from jurisdiction to jurisdiction, and while their eligibility criteria and tax concessions may also be quite disparate, their underlying objectives are essentially the same – they are designed to help companies recruit and retain staff by offering them the opportunity to acquire shares in their employers, often at a discount to the market price, in what is usually a tax-effective manner.\(^3\)

This article outlines the commercial and regulatory background relating to ESOPs (see Parts 2 and 3). This is followed by a detailed examination of how Australia's tax laws currently apply to benefits provided under such schemes (see Parts 4 to 8) and a discussion of how certain proposed reforms recently announced by the Government intend to change the way in which such benefits are taxed (see Part 9). The article compares the policy rationale that underpins both the current and proposed regimes and focuses on how they affect 'start-up companies' and their employees. The article concludes with the author’s views on the merits of the proposed reforms (see Part 10).

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1. It is difficult to identify exactly how many Australian companies have offered ESOPs to their employees over the years due to a lack of empirical data. A study undertaken by the Australian Bureau of Statistics, which relied on estimates from its Survey of Employee Earnings, Benefits and Trade Union Membership, indicated that while only 1.3% of employees received shares as an employment benefit in 1979, this had increased to 5.9% of employees by 2004: Australian Bureau of Statistics, 6105.0 - Australian Labour Market Statistics (July 2005) 23. For a study of the use of ESOPs by Australian listed companies, see Ingrid Landau, Richard Mitchell, Ann O’Connell, Ian Ramsay and Shelley Marshall, ‘Broad-based Employee Share Ownership in Australian Listed Companies: An Empirical Analysis’ (2009) 37 Australian Business Law Review 412.

2. While most countries usually only have one regime for dealing with ESOPs, some countries have a number of different kinds of schemes. For example, the United Kingdom has four schemes: the ‘Share Incentive Plan Scheme’, the ‘Save As You Earn Scheme’, the ‘Company Share Option Plan Scheme’ and the ‘Enterprise Management Incentive Scheme’.

2. **Commercial benefits of ESOPs**

From a company’s perspective, issuing shares or options is a cost-effective form of remuneration as it does not require the company to pay its employees any money and also gives the company an extra avenue for raising capital. ESOPs can therefore provide companies with tangible ‘liquidity’ benefits by allowing them ‘to conserve cash burn while at the same time reward employees for their efforts.’ In theory, these schemes should be especially suitable for entrepreneurial start-up companies that are often heavily involved in R&D and may not have sufficient funds or regular cash flows to be able to recruit key personnel and pay them substantial salaries. Recent studies have revealed that start-ups are usually ‘intent on preserving their limited capital’ and look for ‘low-cost solutions’ which can ‘attract the calibre of employees necessary to get their businesses off the ground.’ The OECD has explained that:

> As stock options over the shares of young, high-growth companies can become very valuable over time, they create incentives for employees to work for such companies even if the cash salaries are less attractive than those offered by larger companies.

ESOPs provide employees with the upside advantage of enabling them to share in the future success of their companies. These plans can therefore mitigate what has often been referred to as the ‘principal-agent problem,’ whereby an employee (the ‘agent’) might otherwise be motivated to act in their own interests rather than those of the company (the ‘principal’). By giving employees the opportunity to acquire a stake in the companies they work for, their interests become more closely aligned

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6 The Australian government has recognised that ESOPs ‘can be an important tool for resource strapped start-ups, as they provide an option to help attract and retain talented people (locally and from overseas) while ensuring sufficient capital is available for the start-up to grow’: The Treasury, *Employee Share Schemes and Start-up Companies: Administrative and Taxation Arrangements* (2013) 1.
8 OECD, above n 4, 11.
9 Australian Government, *Industry Innovation and Competitiveness Agenda – An Action Plan for a Stronger Australia* (2014) 77 (‘Industry Innovation and Competitiveness Agenda’). By participating in ESOPs, employees also gain the opportunity of having ‘a greater say in the governance of the company’: Ingrid Landau et al, above n 3, 54. This gives them more influence in the direction a company is heading.
10 OECD, above n 4, 11.
with those of their employers.\(^{11}\) This has the potential to lead to greater employee commitment and loyalty, which can boost corporate profits and productivity.\(^{12}\) The OECD has described the alignment of employer and employee interests as the ‘central economic argument’ in favour of ESOPs, and it has identified this as one of the two traditional reasons for their popularity; the other reason being that they typically enable companies to compensate employees in what is usually a more tax-effective manner than paying them cash salary.\(^{13}\)

While promoting the alignment of employee and employer interests is the principal rationale given for supporting ESOPs, there are also several other policy reasons why Governments might want to encourage the establishment of such schemes.\(^{14}\) One of these is ‘increasing national savings’ – in particular, the retirement savings of employees.\(^{15}\) Another is facilitating small business ‘succession planning’ and enabling ‘employee buyouts’.\(^{16}\) ESOPs can also indirectly foster the development of a country’s innovation system where they are targeted at supporting dynamic start-up

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\(^{11}\) The fact that ESOPs can benefit both a company and its employees has been widely recognised in the academic literature, including by the Australian Bureau of Statistics, which has noted that these schemes ‘provide a link between corporate and individual performance and can therefore provide extra motivation for employees’: Australian Bureau of Statistics, above n 1, 23. Similar observations have also been made in a recent United Kingdom government commissioned study which stated: ‘At the heart of employee ownership is employee engagement. The extra employee commitment to achieving a company’s goals helps deliver business success. Employees benefit from working in companies they feel committed to and actively participate in. That can make employee owned companies great places to work’: Sharing Success – The Nuttall Review of Employee Ownership (2012) 13 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31706/12-933-sharing-success-nuttall-review-employee-ownership.pdf>.

\(^{12}\) In the first detailed report examining employee share ownership in Australia, it was recognised that the alignment arising from ESOPs allows employees to ‘appreciate more directly the impact of management and work practices on efficiency, productivity and profitability’: House of Representatives Standing Committee on Employment, Education and Workplace Relations, Shared Endeavours – Inquiry into Employee Share Ownership in Australian Enterprises (2000) vii (‘Shared Endeavours’). More recently, the Australian government has also emphasised that ‘international research suggests that companies in which employees have an ownership interest are more productive than those that do not’: Industry Innovation and Competitiveness Agenda, above n 9, 76.


\(^{14}\) For a general discussion of a number of different policy rationales for supporting ESOPs, see Ingrid Landau, Ann O’Connell and Ian Ramsay, Incentivising Employees – The Theory Policy and Practice of Employee Share Ownership Plans in Australia (Melbourne University Press, 2013) 11–13.

\(^{15}\) Shared Endeavours, above n 12, xxv.

\(^{16}\) Ibid.
companies engaged in new and emerging scientific and high-technology industries.\(^{17}\) This is supported by a recent United Kingdom study, which suggests that employee owned companies tend to have a longer-term focus and are more willing to pioneer innovations and seek innovative ideas from their staff.\(^{18}\)

3. Regulation of ESOPs in Australia

In Australia, like in many other countries, ESOPs are subject to a wide variety of regulatory requirements. In particular, the *Corporations Act 2001*(Cth) contains a broad range of disclosure, licensing and other rules\(^{19}\) that companies generally need to comply with in order to operate ESOPs.\(^{20}\) The Australian Securities and Investments Commission ('ASIC') has the power to grant specific exemptions from some of these rules, and it has indicated that it is prepared to provide conditional relief in certain circumstances.\(^{21}\) Furthermore, in accordance with basic corporate law principles, when establishing ESOPs, the directors of a company need to ensure that they act in good faith and in the best interests of the company.\(^{22}\) Bearing in mind that ESOPs can dilute the value of existing shares, they also need to be vigilant in ensuring that these schemes are not contrary to the interests of the members as a whole and are not oppressive to, unfairly prejudicial to, or unfairly discriminatory against, the members.\(^{23}\)

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17 These industries are sometimes referred to as ‘sunrise industries’. A sunrise industry is typically knowledge intensive, is in an emerging area, and is involved in commercialising recently developed technology and/or R&D: ibid xxiii.


19 These other rules relate to matters such as advertising, hawking, incidental operation of a managed investment scheme and the on-sale of financial products.

20 For a general summary of the corporate law framework relating to ESOPs, see Landau et al, above n 3, 74–103.

21 See ASIC, *Employee Incentive Schemes*, Regulatory Guide 49 (October 2014), which states (at 4) that ASIC is prepared to give conditional class order relief from these obligations where: ‘the offer is designed to support interdependence between the employer and its employees for their long-term mutual benefit by aligning their respective interests; there is adequate protection for participants in the scheme; and the objective of the offer is not fundraising.’ ASIC has also indicated that it may also grant case-by-case relief if its policy objectives are met.

22 *Corporations Act 2001* s 184.

23 *Corporations Act 2001* s 232.
4. Taxation of ESOPs in Australia

Since 1 July 2009, Australia’s rules for taxing benefits acquired by employees under ESOPs have been located in Div 83A Income Tax Assessment Act 1997 (ITAA 1997). The rules in Div 83A apply to what are referred to as ‘employee share schemes’ (ESSs) and replace a set of former rules which were previously contained in Div 13A of Pt III Income Tax Assessment Act 1936 (ITAA 1936). Division 83A implemented several important policy changes to the way in which benefits under ESSs are taxed, including the imposition of stricter conditions that have to be met in order for employees to be able to access certain tax concessions under the regime.

Over its short history, Div 83A has been the subject of much criticism. One of the complaints about the Division has been that it is a ‘one-size-fits-all’ regime that does not draw any distinctions between large and small companies or their respective employees. Start-up companies, in particular, have expressed concerns that ESSs can be expensive to establish and administer because of the expenditure involved in seeking legal, financial and accounting advice and undertaking valuations. Stakeholders have also argued that Div 83A only offers minimal tax concessions which are of much more restricted application than the concessions which were previously available under Div 13A. It is significant that under Div 83A, unless certain special conditions are satisfied, employees will generally be taxed on their benefits in the income year in which they acquire their shares or options rather than in the income year in which they sell their shares or exercise their options. This can make Australian ESSs quite unattractive for participants when compared with several overseas schemes, and it has been argued that it places Australian companies at a competitive disadvantage in international markets.

Intense lobbying against Div 83A, particularly by the start-up sector and the venture capital industry, has led the Australian Government to rethink its strategy in relation to ESSs. In October 2014, as part of its Industry Innovation and Competitiveness Agenda, the Government announced that it would make major changes to improve the tax treatment of ESSs. The Government stated that the changes are designed ‘to encourage greater entrepreneurship … so that good ideas can be commercialised in Australia’.

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25 The Treasury, above n 6, 9.
26 Ibid.
28 Industry Innovation and Competitiveness Agenda, above n 9, xx.
A draft version of the Government’s proposed reforms are contained in Tax and Superannuation Laws Amendment (2015 Measures No 1) Bill 2015: Improvements to Taxation of Employee Share Schemes (‘Draft Bill’) and Income Tax Assessment Amendment (Employee Share Schemes) Regulation 2015 (‘Draft Regulations’), which were released for public consultation in January 2015. The reforms aim to improve the tax treatment of ESSs by making a number of important amendments to Div 83A, including providing a special tax concession for employees of eligible start-up companies. In the Explanatory Materials which accompanied the Draft Bill, the Government explained:

These changes will improve the tax treatment of ESSs so as to facilitate better alignment of interests between employers and their employees, and to stimulate the growth of innovative start-ups in Australia by helping small unlisted companies be more competitive in the labour market.29

5. Overview of Division 83A

Division 83A is a highly complex regime that contains an intricate web of inter-related and technical provisions. As mentioned above, Div 83A applies in respect of ‘ESSs’. An ESS is defined as a scheme under which ‘ESS interests’ in a company are provided to employees, or associates of employees, (including past or prospective employees) of the company or its subsidiaries in relation to the employees’ employment.30

An ‘ESS interest’ is a beneficial interest in a share, or a beneficial interest in a right (which would include an option) to acquire a beneficial interest in a share, in a company.31

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30 ITAA 1997 s 83A-10(2).
31 ITAA 1997 s 83A-10(1). Note that the operation of Div 83A is extended by special ‘deeming rules’ that apply to interests held in ‘employee share trusts’. Section 83A-320 ITAA 1997 provides that where an employee holds an interest in a trust that holds shares and the employee’s interest corresponds to a particular number of shares, the employee is deemed to have a beneficial interest in that number of shares for the purposes of Div 83A. This rule applies to rights to acquire beneficial interests in shares in the same way as it applies to shares. For further discussion of how employee share trusts operate in practice, see Sartori, above n 3, 75–76; Landau et al above n 3, 121–123. Note that there are also special deeming rules relating to ‘stapled securities’. Section 83A-335 provides that Div 83A applies to a stapled security in the same way as it applies to a share in a company, if at least one of the ownership interests that are stapled together to form the stapled security is a share in the company.
An ‘associate’ is defined widely and includes persons such as an employee’s relatives.\textsuperscript{32} It also includes certain other entities, such as a company which is sufficiently influenced by, or in which a majority of the voting interests are held by, the employee or their associates.

\textbf{Upfront and deferred taxation}

The underlying aim of Div 83A is to ensure that any ‘discounts’ in respect of ESS interests acquired under an ESS are subject to income tax in the hands of employees at their marginal tax rates.\textsuperscript{33} To prevent employers also being subject to fringe benefits tax on the provision of such benefits, a benefit that is an ESS interest under an ESS is expressly deemed not to constitute a ‘fringe benefit’.\textsuperscript{34}

Division 83A taxes employees on their benefits under either:

- an ‘upfront’ basis (i.e., at the time of acquisition of the shares or options) pursuant to rules in Subdiv 83A-B (see Part 6), or
- a ‘deferred’ basis (i.e., at the time of the occurrence of a specified event) pursuant to rules in Subdiv 83A-C (see Part 7).

In general, the ‘taxing point’ for discounts is usually upfront and, in special cases, the amount assessable to the employee may be reduced by up to $1,000 provided certain requirements are met. The obvious problem with upfront taxation is that employees have to pay tax on their discounts before they have exercised their rights or realised their shares. As employees will not necessarily have the money available to do this, they may therefore be reluctant to participate in ESSs which give rise to upfront taxation treatment.

Deferred taxation can extend the taxing point for benefits for a period of up to seven years. This is beneficial to employees as it delays the time at which they must pay tax and therefore gives rise to concessional treatment. However, the problem with deferred taxation is that it only applies if strict conditions are satisfied, including the requirements that the ESS interests are at ‘real risk of forfeiture’ or obtained under a ‘salary sacrifice arrangement’. In many cases, ESSs established by start-up companies will not meet the conditions for deferred taxation and, as a consequence, the employees of such companies will be required to pay tax on their discounts in the income year in which they receive their shares or rights, even though those shares or rights may turn out to be worthless in the long run.

\textsuperscript{32} ITAA 1997 s 995-1; ITAA 1936 s 318.
\textsuperscript{33} ITAA 1997 s 83A-5(a).
\textsuperscript{34} Fringe Benefits Tax Assessment Act 1986 (Cth) s 136(1) (paragraph (h) in the definition of ‘fringe benefit’).
It is important to be aware that the approach to taxation adopted under Div 83A is quite different to the approach adopted under former Div 13A. Division 83A is, unquestionably, a far less concessionary regime than its predecessor, and is likely to have had an adverse impact on the use of ESSs in Australia.

Under the former rules, employees that received ‘qualifying shares or rights’ under ESSs had a choice of either being taxed on an upfront basis and generally receiving a $1,000 tax exemption or being taxed on a deferred basis under which they could defer tax for a period of up to ten years. Division 83A removes the choice and assesses employees on an upfront basis unless the strict conditions for deferred taxation (which include special requirements that did not exist under Div 13A) are satisfied. In addition, Div 83A only allows employees earning no more than $180,000 in an income year to claim the $1,000 reduction. There was no similar requirement under former Div 13A. Furthermore, Div 83A also shortens the deferral period from a maximum period of ten years to a maximum period of only seven years, exposing employees to an earlier taxing point.

A critical difference between the two divisions is that, under Div 13A, rights were generally taxed when they were ‘exercised’, whereas under Div 83A they are generally taxed when they ‘vest’ in the employee. In its *Industry Innovation and Competitiveness Agenda*, the Government acknowledged that this change ‘is particularly problematic because it taxes employees before they have the opportunity to convert their options to shares and realise any actual gain by selling the underlying shares’. The Government went on to conclude that this ‘effectively ended the provision of ESS options to employees’.

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35 The reason for the different tax treatment was explained in the Explanatory Memorandum to the Bill that introduced Div 83A, which indicated that the new measures were ‘designed to improve horizontal equity in the tax system by treating all forms of remuneration more consistently, to target employee share scheme tax concessions more closely to low and middle income earners, and to reduce the scope for losses to the Commonwealth revenue through tax evasion and avoidance’: Explanatory Memorandum, Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009 and Income Tax (TFN Withholding Tax (ESS)) Bill 2009 (Cth) para 1.15.

36 This contention is supported by data compiled by an independent advocacy group: Employee Ownership Australia & New Zealand, *The Changing ESS Landscape Since 1 July 2009 – Employee Ownership Australia and New Zealand (EOA) Report* (2013) 4. It is also supported by the observations made in a Deloitte/Norton Rose survey report which concludes that the taxation treatment of ESOPs is the ‘main obstacle’ to their ‘more widespread use’: Fryer and Abrahams, above n 7, 1.

37 ITAA 1936 former ss 139B, 139E.

38 ITAA 1936 former s 139CB.

39 *Industry Innovation and Competitiveness Agenda*, above n 9, 77.

40 Ibid.

41 Ibid.
Interaction of Div 83A with the general tax rules

While Div 83A constitutes the sole regime for taxing discounts in relation to ESS interests, it is not intended to operate beyond the relevant taxing point and is designed to work coherently with the general tax rules contained in the rest of the income tax legislation. Accordingly, once discounts have been taxed on either an upfront or deferred basis under Div 83A, any subsequent transactions relating to ESS interests will not fall within Div 83A, but will instead be subject to taxation under the general tax rules. For example, where a share acquired by an employee under an ESS is disposed of, any gain or loss the employee makes on its disposal will usually be taxed under the CGT rules.

Furthermore, although both shares and rights constitute ESS interests, Subdiv 83A-B does not apply to any shares that have been acquired as a result of the exercise of a right under an ESS. This recognises that where upfront taxation has already applied to the right, the taxation treatment of any shares obtained by exercising the right should not come within the operation of Div 83A, but rather fall within the operation of the general tax rules.

There is also a special rule which provides that Div 83A is taken never to have applied in relation to an ESS interest if the employee has been assessed on the interest but it is subsequently forfeited. However, this rule only applies if the forfeiture did not result from a choice made by the employee (other than a choice to cease employment), or a condition of the scheme that has the direct effect of protecting (wholly or partly) against a fall in the market value of the interest.

Employees taxed on ESS interests provided to associates

In order to prevent Div 83A being manipulated, where an ESS interest has been acquired by an employee’s associate, it is treated as if it was acquired by the employee

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42 To prevent capital gains and capital losses arising from CGT events relating to an ESS interest, gains and losses are generally disregarded to the extent that the CGT event happens at or before the relevant taxing point: ITAA 1997 s 130–80.
43 Special modifications are made to the general CGT rules under Subdiv 130-D ITAA 1997 to ensure that they align and operate consistently with the rules in Div 83A.
44 ITAA 1997 s 83A-20(2).
45 ITAA 1997 s 83A-310.
46 Where this special rule operates, any tax paid by the employee in respect of the ESS interest will need to be refunded to them. Employees will need to have their earlier year assessments amended to receive any refunds resulting from the operation of s 83A-310. The Commissioner is specifically empowered to amend an employee’s previous year assessment at any time to give effect to this provision: ITAA 1936 s 170(10AA).
rather than the associate. This means, for instance, that if an employee’s spouse acquires shares under an ESS, the employee (rather than the spouse) is required to include the relevant discount in their assessable income. The object of this rule is to prevent the discount on the ESS interest being taxed at the associate’s tax rate (which may be lower than the employee’s tax rate). It is important to recognise, however, that when the shares are subsequently disposed of by the associate, any capital gain or capital loss arising from the CGT event will be made by the associate (rather than the employee).

**Valuing ESS interests**

One of the key issues that arises under Div 83A concerns the valuation of an ESS interest, as this is relevant in calculating the discount that is assessable to an employee. Generally, the value of an ESS interest will be its ‘market value’. However, since it is particularly difficult to value unlisted rights to acquire shares, special ‘safe harbour’ rules contained in Div 83A of the Income Tax Assessment Regulations 1997 (ITAR 1997) can be used to determine the value of such rights. The regulations are complex and a detailed technical examination of them is beyond the scope of this article. Nevertheless, in broad terms, they generally provide that an employee has the choice of valuing an unlisted right on a particular day at either its market value or the greater of the following values:

- the market value, on the day, of the share that may be acquired by exercising the right, less the lowest amount that must be paid to exercise the right to acquire the share; and
- the value determined in accordance with regs 83A-315.03 to 83A-315.09.

Regulations 83A-315.02 to 83A-315.09 contain different rules for determining the value of a right depending on the relevant circumstances. Under these rules, if the

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47 ITAA 1997 s 83A-305.
49 ITAA 1997 s 83A-315. The regulations apply to unlisted rights that must be exercised within 10 years after the day when the beneficial interest in the rights were acquired: ITAR 1997 reg 83A-315.01.
50 ITAR 1997 regs 83A-315.01, 83A-315.02.
lowest amount that must be paid to exercise the right is nil, or cannot be determined, the value of the right is deemed to be the market value of the share on the particular day.\textsuperscript{51} Otherwise, the value of a right is determined according to a number of steps, which are based on the application of specified formulas. The formulas use calculation percentages that are set out in tables and vary depending on the exercise period of the grant of the right.\textsuperscript{52}

\textbf{Reporting and withholding obligations of companies that provide ESSs}

Division 83A operates alongside special reporting and withholding rules which are imposed on companies that establish ESSs. Where a company provides an ESS interest to an employee, it must give a statement in the approved form to the employee\textsuperscript{53} and the Commissioner.\textsuperscript{54} The statement must contain prescribed information relating to the scheme, including details of the company’s estimate of the market value of the ESS interest at the time of acquisition.\textsuperscript{55} Furthermore, where employees have not provided their ABN or TFN to the company by the end of an income year in which an amount is assessable, the company is required to pay ‘TFN withholding tax (ESS)’ under the \textit{Income Tax (TFN Withholding Tax (ESS)) Act 2009}.\textsuperscript{56} The tax is payable at the rate of 49\% (for the 2014/15 to 2016/17 income years) on the relevant discount.\textsuperscript{57}

\textbf{Diagrammatic outline of the ESS regime}

The following diagram outlines the basic structure of how Div 83A operates. The key elements in the diagram are examined in further detail in Parts 4 and 5 of this article.

\textsuperscript{51} ITAR 1997 reg 83A-315.03.
\textsuperscript{52} ITAR 1997 regs 83A-315.06 - 83A-315.09.
\textsuperscript{53} The statement must be provided to the employee no later than 14 July after the end of the income year: \textit{Taxation Administration Act 1953} (‘TAA’) Sch 1 s 392-5(a).
\textsuperscript{54} The statement must be provided to the Commissioner no later than 14 August after the end of the income year: TAA Sch 1 s 392-5(b).
\textsuperscript{55} TAA Sch 1 s 392-5. Non-compliance with this requirement can give rise to an administrative penalty under TAA Sch 1 s 286-75(2BA).
\textsuperscript{56} TAA Sch 1 s 14-155. The company can recover any TFN withholding tax (ESS) that it is required to pay from the employee as a debt under TAA Sch 1 s 14-165.
\textsuperscript{57} \textit{Income Tax (TFN Withholding Tax (ESS)) Act 2009} s 4. This rate is pinned to the top marginal income tax rate plus Medicare levy and temporary budget repair levy rate. The rate will revert to 47\% from the 2017/18 income year on account of the removal of the temporary budget repair levy.
### Application of Div 83A
Div 83A applies where there is a scheme under which ESS interests in a company are provided to employees or associates of employees of the company or its subsidiaries in relation to the employees’ employment at a discount (ss 83A-10, 83A-20, 83A-105).

### Taxation treatment under Div 83A
The taxation treatment of an ESS interest depends on the answer to the following question: 
Is the ESS interest at real risk of forfeiture or acquired under a salary sacrifice arrangement and are the other relevant conditions in s 83A-105 satisfied?

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<thead>
<tr>
<th>If the answer to the question is <strong>NO</strong>, then</th>
<th>If the answer to the question is <strong>YES</strong>, then</th>
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<tr>
<td><strong>UPFRONT TAXATION</strong> applies</td>
<td><strong>DEFERRED TAXATION</strong> applies</td>
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### Assessable amount
The employee is assessed on the discount at the time of acquisition of the ESS interest (s 83A-25).

| The employee is assessed at the ESS deferred taxing point (s 83A-115, s 83A-120) on the market value of the ESS interest at the ESS deferred taxing point reduced by the cost base of the interest (s 83A-110) |

### Employee reduction and employer deduction
Where the relevant eligibility criteria are met, the employee is eligible for a reduction concession of up to $1,000 in the amount assessable under s 83A-25 (s 83A-35) and the employer is entitled a deduction of up to $1,000 for each eligible employee (s 83A-205).

| Where an eligible corporate restructure or takeover has taken place, the deferred taxing point is rolled over (i.e., it is not affected by the restructure or takeover) (s 83A-130) |

### Acquisition of ESS interest
For the purposes of the general income tax rules, the ESS interest is taken to have been acquired for its market value (s 83A-30).

| For the purposes of the general income tax rules, the ESS interest is taken to have been acquired for its market value at, or immediately after, the ESS deferred taxing point (s 83A-125) |

### Relief where ESS interest is forfeited
Div 83A is taken never to have applied in relation to an ESS interest if an employee would otherwise be assessed in relation to the ESS interest but it is subsequently forfeited (so long as the forfeiture does not result from a choice made by the employee other than a choice to cease employment) (s 83A-310).
6. **Upfront taxation under Subdivision 83A-B**

The general (‘default’) position under Div 83A is that upfront taxation treatment usually applies to employees who have acquired, or whose associates have acquired, ESS interests at a discount under an ESS.\(^{58}\) The upfront taxation rules are located in Subdiv 83A-B and do not apply if Subdiv 83A-C applies (i.e., they do not apply where the conditions for deferred taxation treatment are satisfied).\(^{59}\)

**Discount included in assessable income**

Under Subdiv 83A-B, discounts in relation to ESS interests are required to be included in an employee’s assessable income in the year the ESS interest is acquired.\(^{60}\) The term ‘discount’ is not defined under the legislation and therefore takes its ordinary meaning. It is generally calculated as ‘the difference between the market value of the share or right and any consideration paid by the employee to acquire the share or right.’\(^{61}\)

The main policy rationale for adopting upfront taxation treatment is that it supports the principle of ‘horizontal equity’ by ensuring that discounts are assessed consistently with other forms of remuneration, such as salary, which is also assessed in the hands of employees in the income year of receipt.\(^{62}\)

**Reduction concession for employees and deduction for companies**

Where Subdiv 83A-B applies, the employee may be entitled to a special concession that allows them to reduce the amount they would otherwise be assessed on by up to $1,000.\(^{63}\) To qualify for the reduction, the following eligibility criteria must be satisfied:

- the sum of the employee’s ‘taxable income’, ‘reportable fringe benefits total’, ‘reportable superannuation contributions’, and ‘total net investment loss’ for the income year must not exceed $180,000;\(^{64}\)

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58 ITAA 1997 s 83A-20(1).
59 ITAA 1997 s 83A-105.
60 ITAA 1997 s 83A-25(1). To the extent that a discount is attributable to employment outside Australia, it is treated as foreign source income: s 83A-25(2). This means that a foreign resident is only assessed on that part of the discount that relates to their employment in Australia.
61 The Board of Taxation, *Review into the Elements of the Taxation of Employee Share Scheme Arrangements* (2010) 5. Note, however, that employees may use special rules to value certain ESS interests (i.e., unlisted rights) under the ITAR 1997: ITAA 1997 s 83A-315.
62 Upfront taxation treatment is also consistent with the way in which fringe benefits are taxed in Australia. Under the *Fringe Benefits Tax Assessment Act 1986*, employers are required to include the taxable values of fringe benefits provided during a year of tax in the calculation of their ‘fringe benefits taxable amount’ for that year.
63 ITAA 1997 s 83A-35(1).
64 ITAA 1997 s 83A-35(2).
the employee must be employed by the company that provides the ESS interest or by one of its subsidiaries;\(^\text{65}\)

- the ESS interest must relate only to ordinary shares;\(^\text{66}\)

- the predominant business of the company must not be the acquisition, sale or holding of shares, securities or other investments;\(^\text{67}\)

- the ESS must be offered on a non-discriminatory basis to at least 75% of the permanent employees of the company who have completed three years of service (whether continuous or not) and are Australian residents;\(^\text{68}\)

- there must be no real risk under the conditions of the ESS that the ESS interest (or shares acquired by the exercise of rights) will be forfeited;\(^\text{69}\)

- the ESS must require the employee to hold the ESS interest for at least three years or until the employee ceases employment;\(^\text{70}\)

- immediately after acquiring the interest, the employee must not hold more than 5% of the shares in the company or be in a position to cast more than 5% of the votes at a general meeting.\(^\text{71}\)

In order to encourage companies to establish ESSs, where an employee qualifies for the reduction, the company that has provided the ESS interest is also eligible for a corresponding deduction of an identical amount.\(^\text{72}\) The deduction is available in respect of each qualifying employee (i.e., it operates on a ‘per employee basis’). For the purposes of claiming the deduction, in determining whether an employee qualifies for the reduction concession, the $180,000 income requirement mentioned in the first point above is ignored. In other words, the company is still entitled to a deduction for employees that earn above this figure provided the other requirements mentioned in the points above have been fulfilled.

**Deemed cost of acquiring the ESS interest**

An ESS interest that has been subject to upfront taxation under Subdiv 83A-B is treated as having been acquired for its market value.\(^\text{73}\) This recognises that the employee has been assessed on the discount and should therefore not simply be treated as having acquired the ESS interest for the amount paid for the interest. The market value of the share or right, rather than its discounted value, will therefore be used in calculating any gain or loss that subsequently arises from the disposal of the share or right under the general tax rules.

\(^\text{65}\) ITAA 1997 s 83A-35(3).
\(^\text{66}\) ITAA 1997 s 83A-35(4).
\(^\text{67}\) ITAA 1997 s 83A-35(5).
\(^\text{68}\) ITAA 1997 s 83A-35(6).
\(^\text{69}\) ITAA 1997 s 83A-35(7).
\(^\text{70}\) ITAA 1997 s 83A-35(8).
\(^\text{71}\) ITAA 1997 s 83A-35(9).
\(^\text{72}\) ITAA 1997 s 83A-205.
\(^\text{73}\) ITAA 1997 ss 83A-30, 130-80.
Example

The following example provides a simple illustration of how the rules in Subdiv 83A-B operate.

**Generous Co** is a company that established an ESS. On 1 December 2014, Carol acquired 1,000 ordinary shares in the company under the ESS for $20,000. Assume the shares have a market value of $50,000 and that upfront taxation applies. Assume also that all the eligibility requirements for the reduction concession are met.

For the 2014/15 income year, Carol will be required to include an amount of $29,000 in her assessable income, being the amount of the discount (i.e., $30,000) less the reduction concession (i.e., $1,000). Generous Co is also entitled to a $1,000 deduction in respect of Carol.

Carol is deemed to have acquired the 1,000 shares in Generous Co for $50,000 (i.e., $50 per share) on 1 December 2014 even though she only paid $20,000 (i.e., $20 per share). If she subsequently sells the 1,000 shares on 5 May 2015 for $60,000, she will make a capital gain of $10,000 (i.e., $10 per share).

7. **Deferred taxation under Subdivision 83A-C**

Employees are entitled to concessional treatment in that they are assessed on a deferred basis if certain conditions are satisfied, including the condition that their ESS interest is at ‘real risk of forfeiture’ or is obtained under a ‘salary sacrifice arrangement’. In these circumstances, the rules in Subdiv 83A-C apply instead of the rules in Subdiv 83A-B.\(^{74}\)

**General conditions**

Under Subdiv 83A-C, the general conditions that must be satisfied for deferred taxation to apply are as follows:

- the employee must be employed by the company that provides the ESS interest or by one of its subsidiaries;
- the ESS interest must relate only to ordinary shares;
- the predominant business of the company must not be the acquisition, sale or holding of shares, securities or other investments; and

\(^{74}\) ITAA 1997 s 83A-105.
immediately after acquiring the interest, the employee must not hold more than 5% of the shares in the company or be in a position to cast more than 5% of the votes at a general meeting.\textsuperscript{75}

In addition, for deferred taxation to apply in respect of an ESS interest that is a share, there is a further condition that at the time the employee acquired the ESS interest, at least 75% of the permanent employees of the employer who have completed three years of service (whether continuous or non-continuous) and who are Australian residents must be entitled to acquire ESS interests under the scheme or another ESS with the employer or its holding company.\textsuperscript{76}

**Real risk of forfeiture condition**

An ESS interest is at ‘real risk of forfeiture’ in the following circumstances:

- if the ESS interest is a beneficial interest in a share – there is a real risk that, under the conditions of the scheme, the employee would forfeit or lose the share (other than by disposing of it); or
- if the ESS interest is a beneficial interest in a right to acquire a beneficial interest in a share – there is a real risk that, under the conditions of the scheme, the employee would forfeit or lose the right (other than by disposing of it, exercising it or letting it lapse) or, there is a real risk that, under the conditions of the scheme, if the right is exercised, the employee would forfeit or lose the shares (other than by disposing of them).\textsuperscript{77}

The ATO is of the view that whether or not a real risk of forfeiture or loss is present in a particular case depends on the facts of each scheme and the employee’s individual circumstances.\textsuperscript{78} The ATO applies a ‘reasonable person test’ whereby it treats an ESS interest as being at real risk of forfeiture or loss ‘if a reasonable person would consider that there is a real risk that the employee may forfeit or lose the ESS interest, other than by intentionally taking no action to realise the benefit.’ The risk of forfeiture must be ‘genuine’ and ‘not artificial’ and must be more than a ‘mere possibility’ or ‘rare eventuality’.\textsuperscript{79} A real risk of forfeiture might arise, for example, in situations where the conditions of the ESS provide that the employee will lose their ESS interest

\textsuperscript{75} ITAA 1997 s 83A-105(1).
\textsuperscript{76} ITAA 1997 ss 83A-105(1)(c), (2).
\textsuperscript{77} ITAA 1997 s 83A-105(3).
if they have failed to meet certain performance hurdles or if they have not completed a minimum period of employment.80

**Salary sacrifice arrangement condition**

A ‘salary sacrifice arrangement’ arises if the ESS interest is an interest in shares and is acquired in return for a reduction in the employee’s salary or wages, or as part of their remuneration package.81 In addition, the following criteria must also be satisfied:

- the discount must equal the market value of the ESS interest (i.e., the employee must have provided no consideration for the shares);
- all ESS interests available for acquisition under the ESS must be at real risk of forfeiture and/or be beneficial interests in shares;
- the governing rules of the ESS must state that deferred taxation applies; and
- the market value of the ESS interests acquired by the employee in the employer and any holding company of the employer must not exceed $5,000 during the income year.

The $5,000 limit makes salary sacrifice arrangements impractical for employers who wish to heavily incentivise particular employees by issuing them with a substantial number of shares.

**ESS deferred taxing point**

Where the conditions for deferred taxation have been fulfilled, the discount is assessed at the ‘ESS deferred taxing point’, which is determined as follows:

- In the case of ESS interests that are beneficial interests in shares, the ESS deferred taxing point is the *earliest* of the following times:
  - when there is no real risk of forfeiture or loss of the shares and there are no genuine restrictions preventing disposal;82
  - when the employee ceases their employment in respect of which they acquired the shares;83 or
  - seven years after the shares were acquired.84

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80 The ATO accepts that there is a real risk of forfeiture ‘where the minimum term of employment is at least six months and the maximum deferral is no more than three years; or where the minimum term of employment is at least 12 months.’: Australian Taxation Office, *Minimum Term of Employment* (25 September 2013) <https://www.ato.gov.au/General/Employee-share-schemes/In-detail/Restrictions-and-forfeiture/Real-risk-of-forfeiture/?page=5#Minimum_term_of_employment>.
81 ITAA 1997 s 83A-105(4).
82 ITAA 1997 s 83A-115(4).
83 ITAA 1997 s 83A-115(5).
84 ITAA 1997 s 83A-115(6).
In the case of ESS interests that are beneficial interests in rights to acquire beneficial interests in shares, the ESS deferred taxing point is the *earliest* of the following times:

- when there is no real risk of forfeiture or loss of the rights and there are no genuine restrictions preventing their disposal;\(^85\)
- when there is no real risk of forfeiture or loss of the rights, there are no genuine restrictions preventing their exercise, and there is no real risk of forfeiture or loss of the resulting shares or genuine restrictions preventing their disposal;\(^86\)
- when the employee ceases their employment in respect of which they acquired the rights;\(^87\) or
- seven years after the rights were acquired.\(^88\)

The above rules operate subject to a special ‘30-day rule’, which provides that if the employee disposes of an ESS interest within 30 days of the ESS deferred taxing point, the ESS deferred taxing point is taken to be the date of disposal.\(^89\) In certain cases, the operation of the 30-day rule can push the deferred taxing point from one income year into the next.\(^90\)

There is also a special rule which is designed to avoid an ESS deferred taxing point being triggered as a consequence of an employee’s ESS interests having been disposed of or their employment changing due to the takeover or restructure of their employer.\(^91\)

**Amount included in assessable income**

Under Subdiv 83A-C, an employee’s assessable income for the income year in which the ESS deferred taxing point occurs includes the market value of the ESS interest at the ESS deferred taxing point, reduced by the ‘cost base’ of the ESS interest.\(^92\) The cost

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85 ITAA 1997 s 83A-120(4).
86 ITAA 1997 s 83A-120(7).
87 ITAA 1997 s 83A-120(5).
88 ITAA 1997 s 83A-120(6).
89 ITAA 1997 ss 83A-115(3), 83A-120(3).
90 For example, if the deferred taxing point would otherwise be 21 June 2014, but the employee subsequently disposed of their shares on 7 July 2014, the deferred taxing point is deemed to be 7 July 2014.
91 ITAA 1997 s 83A-130. According to this section where employees acquire ‘new interests’ in a company in connection with a takeover or restructure of an ‘old company’ in which they held ESS interests, the new interests are treated as a ‘continuation’ of the ‘old interests’. Any consideration paid when the employee acquired the old interests is spread over the new interests (and any remaining old interests) in proportion to their market values immediately after the restructure.
92 ITAA 1997 s 83A-110(1). To the extent that a discount is attributable to employment outside Australia, it is treated as foreign source income. A foreign resident is therefore only assessed on that part of the discount that relates to their employment in Australia.
base of an ESS interest is determined according to the general CGT rules. It would, therefore, include any consideration paid to acquire the interest as well as any incidental costs. There is, however, no $1,000 reduction concession available under Subdiv 83A-C as is the case under Subdiv 83A-B.

**Deemed cost of acquiring the ESS interest**

An ESS interest that has been subject to deferred taxation is taken to have been acquired for its market value immediately after the ESS deferred taxing point. However, if the ESS deferred taxing point occurs on the disposal of the interest, it is taken to have been acquired at that time. Again, as discussed above, this takes into account the fact that the employee has been assessed on the discount.

**Example**

The following example provides a simple illustration of how the rules in Subdiv 83A-C operate.

Enterprise Co is a company that established an ESS. Spock is one of the company’s employees. On 1 March 2015, Spock paid $2,000 for rights under the ESS to acquire 10,000 shares in Enterprise Co for $5 per share. The ESS requires Spock to work for Enterprise Co for a period of five years and achieve specified sales targets before he can exercise the rights which will expire in 10 years’ time.

As Spock has to work for five years and achieve specified sales targets before he can exercise the rights, there is a real risk of forfeiture of the rights. Assuming all the other conditions for deferred taxation are satisfied, Spock will be taxed on the benefit at the ESS deferred taxing point. The ESS deferred taxing point is five years after he acquired the rights (i.e., 1 March 2020). If the market value of the rights at the ESS deferred taxing point is $50,000, Spock will be assessed on $48,000 (i.e., $50,000 - $2,000) in the 2019/20 income year. He will also be deemed to have acquired the rights at this time for $50,000.

8. **Application of Div 83A to start-up companies**

As previously mentioned, ESSs should theoretically be of greatest benefit to start-up companies. However, these entities have frequently complained about the way in which Div 83A operates, arguing that the rules are overly complex and do not adequately support them. This contention was reinforced in a 2012 study, which

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93 ITAA 1997 Subdiv 110-A.
94 ITAA 1997 ss 83A-125, 130-80.
recognised the many challenges faced by Australian start-ups in reaching ‘scale stage’. The study specifically identified that one of these challenges was the challenge of recruiting and retaining talented staff during the ‘critical growth stage.’ The report went on to note that there were ‘significant issues’ in compensating employees of start-ups and in establishing ‘simple’ ESSs. It was also contended that ESSs were expensive for start-ups and that a modified taxation regime for these companies would ‘motivate more people to take entrepreneurial risk.’

The need for special taxation arrangements for start-up companies is not a novel idea and had been previously raised by the House of Representatives Standing Committee on Employment, Education and Workplace Relations back in 2000 in a report that considered former Div 13A. The Committee stated:

Emerging ‘sunrise’ industries require specific preferential tax treatment for a defined start-up period if high calibre individuals are to be recruited from a highly mobile international labour market.

The Committee went on to recommend that public policy should be formulated to promote employee share ownership to facilitate the development and growth of ‘sunrise enterprises’ (especially in the biotechnology, high technology and IT sectors). Unfortunately, however, this policy objective was never embedded in either Div 13A or Div 83A. It has, nevertheless, remained a constant underlying theme in the ongoing policy debate surrounding the possible reform of Australia’s ESS rules.

2010 Board of Taxation Review of Div 83A

Although Div 83A has only been in existence for just over five years, it is interesting to note that it has received significant political attention from both of Australia’s major political parties. In 2010, shortly after the introduction of Div 83A, the Board of Taxation provided a report to the Assistant Treasurer on various elements of the Division. The Board recognised that, because of their ‘cash-strapped’ financial status, start-up companies tend to rely on offering equity remuneration to their key employees. However, it also noted that there was evidence that the take up of ESS arrangements by unlisted companies was much lower than by listed companies.

The Board acknowledged that there was merit in the argument that the restrictions

95 Morle et al, above n 5, 25.
96 Ibid.
97 Ibid.
98 Shared Endeavours, above n 12, ix.
99 Ibid xxv, xxxii.
100 The Board of Taxation, above n 61.
101 Ibid ix.
102 Ibid.
that limit access to the existing ESS tax deferral arrangements operated onerously on start-ups – in particular, it was pointed out that they struggled with the ‘ordinary shares’, ‘75% of permanent employees’, ‘5% of shares or voting interests’ and ‘real risk of forfeiture’ restrictions.\(^{103}\)

The Board, nevertheless, considered that because of the ‘disparate nature’ of start-up, R&D and speculative style companies, it was fundamentally difficult to define which entities should be eligible for relaxed restrictions. It therefore recommended against any relaxation of the rules on the basis of ‘integrity concerns’ resulting from ‘the inability to adequately ring-fence eligibility’.\(^{104}\) Ultimately, the Board concluded that it would be better to provide any additional support for these companies through more targeted support mechanisms\(^{105}\) (such as the ‘Commercialisation Australia’ program\(^{106}\) and the ‘R&D tax incentive’\(^{107}\)).

### 2013 Labor Government review of Div 83A

Stakeholders were generally dissatisfied with the Board of Taxation’s decision not to recommend any special concessions for start-ups and they continued to lobby the Government for reform. This eventually prompted the Labor Government to announce a review of how Div 83A operates in respect of start-ups.\(^{108}\) Matters for consideration by the review included reducing the administrative burden of establishing ESSs, adjusting the valuation rules for rights under ESSs, and examining the point at which rights are taxed under ESSs.

\(^{103}\) Ibid.

\(^{104}\) Ibid.

\(^{105}\) Ibid.

\(^{106}\) The Commercialisation Australia program was a Commonwealth scheme introduced in 2009 to replace the former ‘Commercial Ready’ program. Its principal aim was to assist companies commercialise their R&D. Assistance was provided by way of direct competitive grants made to companies for eligible expenditure incurred on activities such as: obtaining advice and services to assist in the commercialisation process; employing experienced executives; and establishing the commercial viability of a new product or service. The Commercialisation Australia program also provided business advice to companies by ‘Case Managers’. The Commercialisation Australia program was terminated in 2014 and replaced with the new ‘Entrepreneurs’ Infrastructure Program’.

\(^{107}\) At the relevant time, the R&D tax incentive provided a range of special deductions for expenditure on R&D activities: ITAA 1936 s 73B. Since 1 July 2011, tax incentives for R&D are now provided by way of tax offsets: ITAA 1997, Div 355.

In August 2013, as the first stage of the review process, the Government released a discussion paper, entitled Employee Share Schemes and Start-up Companies: Administrative and Taxation Arrangements.\(^{109}\) In the foreword to the discussion paper, the Government emphasised the significance of the start-up sector for Australia’s future productivity and its place as ‘a thriving hub for innovative industry’.\(^{110}\) It also highlighted the importance of having effective ESS rules for start-up companies as they ‘help attract and retain talented people (locally and from overseas) while ensuring sufficient capital is available for the start-up to grow’.\(^{111}\)

The discussion paper noted that several industry sectors had concerns that Div 83A was ‘inconsistent and out of step with global practice’ because it generally requires tax to be paid on shares or options at the time of acquisition rather than disposal.\(^{112}\) It was pointed out that since few start-ups will actually become sustainable companies, tax is required to be paid on shares and options that may never have a ‘convertible or realised value’ to employees.\(^{113}\) It was also recognised that employees who are provided with shares or options for little or no upfront cost may not actually have the cash available to pay the tax owing on such benefits.\(^{114}\) The discussion paper went on to note that stakeholders argued that the existing tax treatment may create additional barriers to venture capital investment in Australian enterprises, as many venture capital funds will only invest in start-ups that have an ESS as this allows the start-ups to have more capital available to focus on growth.\(^{115}\)

The discussion paper identified the following possible alternatives to the existing tax treatment of ESSs:

- defer the taxing point for securities offered by start-ups to the ‘ESS deferred taxing point’ rather than when acquired;\(^{116}\)
- defer the taxing point for securities offered by start-ups to the point where the share or option is sold or exercised;\(^{117}\)
- tax the discount on securities offered by start-ups in the year of acquisition, but at a lower rate (e.g., 15%);\(^{118}\) or
- tax the discount on securities offered by start-ups in the year of acquisition, but increase the $1,000 concession to $5,000.\(^{119}\)

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109 The Treasury, above n 6, 1.
110 Ibid.
111 Ibid.
112 Ibid 6.
113 Ibid.
114 Ibid.
115 Ibid.
116 Ibid 18-19.
119 Ibid 21-22.
Various potential methods for valuing shares and options in start-up companies were also canvassed in the discussion paper. In addition, it sought views on the adoption of a possible definition of a ‘start-up company’ which could be used for the purposes of access to the concessional taxation rules.

9. Proposed reforms to the taxation of ESSs

In September 2013, a Liberal-National Coalition Government was elected to replace the Labor Government. The new Coalition Government made it clear from early on that it was also committed to addressing the concerns raised by start-up companies in relation to ESSs. In January 2014, following on from the work commenced by the Labor Government under its ESS review, the Coalition Government undertook further consultations with stakeholders to discuss their concerns. Issues raised from this consultation process were referred to a special Taskforce established by the Prime Minister, which considered the treatment of ESSs alongside a number of other issues relating to national competitiveness, productivity, innovation and commercialisation.

The Government’s position on ESSs was eventually set out in its October 2014 Industry Innovation and Competitiveness Agenda report, which indicated that the Government would change the way in which ESSs are taxed under Div 83A. As previously mentioned, the proposed reforms are now contained in the Draft Bill and Draft Regulations which were released in January 2015. Very broadly, the proposed reforms aim to improve the tax treatment of ESSs in three principal ways (which are outlined in further detail below):

- first, they propose to remove some of the ‘draconian’ aspects of the current rules in Div 83A by allowing greater access to deferred taxation arrangements for rights;
- secondly, they propose to introduce a new tax concession specifically targeted at employees of start-up companies; and
- thirdly, they propose to change the safe harbour valuation rules.

120 The particular methods considered were the ‘net asset backing’ method, the ‘Australian Accounting Standards Board Standard No 2’ method and various ‘formula-based’ methods: Ibid 25-26.

121 The definition proposed was a business that: has no more than 15 employees; has an aggregated turnover of less than $5m and is not a subsidiary, owned or controlled by another corporation; has been in existence for [five/seven] years or less; is not undertaking an excluded activity or is providing new products, processes or services based on the development and commercialisation of intellectual property; is unlisted and has the majority of its employees and assets in Australia: Ibid 16-17.
In the Explanatory Materials which accompanied the Draft Bill, the government explained:

The changes are designed to make Australia’s taxation of ESSs more competitive by international standards and to facilitate the commercialisation of innovative ideas in Australia. The changes will assist innovative Australian firms to attract and retain high quality employees in the international labour market.122

**Greater access to deferred taxation arrangements for rights**

At the heart of the proposed reforms is the principle that while the Government will maintain the status quo of having upfront taxation operate as the default basis for taxing discounts on shares and rights, it will be much easier under the new rules for rights to qualify for deferred taxation as the ‘real risk of forfeiture’ condition will be removed for rights.123 In effect, this means that the changes made in 2009 as a consequence of the introduction of Div 83A to the taxing point for rights will be reversed. Under the proposals, provided certain basic conditions are met, rights will generally be taxed when they are exercised, rather than when they are received. The rationale for making this change is that it ‘will defer the taxing point to a point at which most employees can take some practical action to realise the benefits of the underlying share.’124 The reform is a sensible measure as it directly addresses the major issue that has frustrated the use of rights under ESSs in Australia in the post-Div 13A environment.

The Government also plans to increase the maximum deferral period (for both shares and rights) from seven years under the current rules to 15 years under the proposed new rules.125 It is worth noting that the new maximum deferral period is not only more than double the deferral period under Div 83A, it is also five years longer than the 10 year maximum deferral period that existed under former Div 13A. This generous concession is likely to provide a substantial benefit for employees of start-up companies, as it recognises that these companies may take several years to become successful.126

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122 Explanatory Materials, above n 29, 1.5.
123 Draft Bill, proposed s 83A-120(7). See also *Industry Innovation and Competitiveness Agenda*, above n 9, 80. Note that the government has expressly stated that it will retain the existing $1,000 reduction concession, which applies to employees who earn less than $180,000 and are taxed on an upfront basis: at 78.
124 *Industry Innovation and Competitiveness Agenda*, above n 9, 77.
125 Draft Bill proposed ss 83A-115(6), 83A-120(6).
126 As a general rule, the longer deferral period is likely to especially benefit start-ups engaged in sectors such as the biotechnology and pharmaceutical industries which usually have to go through long and rigorous testing phases before they are able to commercialise their products. It is likely to be less important to a sector such as information technology where commercialisation tends to be a relatively more ‘rapid’ process (although this is not always the case).
Another key feature of the proposed reforms is that they include a new concession that is specifically targeted at employees of eligible start-up companies.127 The concession effectively exempts such persons from up-front taxation on discounts relating to ESS interests by reducing the amount that would otherwise be assessable to them under s 83A-25 of the ITAA 1997.128 To qualify for the concession a number of conditions need to be satisfied. The main conditions are outlined below:

- The company in which the ESS interest is issued must be unlisted,129 incorporated for less than 10 years130 and have no more than $50 million aggregated turnover,131 and its predominant business must not be the acquisition, sale or holding of shares, securities or other investments.132
- If the ESS interest is a share, the discount must be less than 15% of the market value of the share when it is acquired. If the ESS interest is a right, the amount that must be paid to exercise the right must be greater than or equal to the market value of an ordinary share in the company when the ESS interest is acquired.133
- The employees must be employed by the company issuing the ESS interest (or its subsidiary)134 and all ESS interests available for acquisition under the scheme must relate to ordinary shares.135
- The scheme must be operated on the basis that the employee is not permitted to dispose of their ESS interests (or their shares acquired as a result of exercising rights under the scheme) before the earlier of three years or when they cease employment.136
- Immediately after acquiring their ESS interests, the employee must not hold a beneficial interest of more than 10% of the shares in the company or control more than 10% of the voting rights in the company.137

127 Industry Innovation and Competitiveness Agenda, above n 9, 78.
128 Draft Bill proposed s 83A-33(1).
129 Draft Bill proposed s 83A-33(2).
130 Draft Bill proposed s 83A-33(3). Note that this requirement also relates to the company’s subsidiaries and holding company.
131 Draft Bill proposed s 83A-33(4).
132 Draft Bill proposed s 83A-45(3).
133 Draft Bill proposed s 83A-33(5).
134 Draft Bill proposed s 83A-45(1).
135 Draft Bill proposed s 83A-45(2).
136 Draft Bill proposed s 83A-45(4).
137 Draft Bill proposed s 83A-45(5). In determining their beneficial interests in shares and voting rights, an employee must take into account any rights they hold to acquire shares as if they actually held those shares (regardless of whether those rights are ESS interests): proposed s 83A-45(6).
The employee’s employer (which may or may not be the company issuing the ESS interest) must be an Australian resident at the time the taxpayer acquires their ESS interest.\textsuperscript{138}

It is interesting to observe that the Draft Bill does not use the concept of a ‘start-up’ (which was the term referred to in the \textit{Industry Innovation and Competitiveness Agenda} report), but rather simply requires the company in which the relevant ESS interests are issued to meet certain basic conditions which should generally be easy to satisfy. It is worth noting that the Government is not quarantining the concession to any particular sectors,\textsuperscript{139} and there is no special condition that the company must be engaged in, for example, a particular kind of high-tech industry such as information technology or biotechnology. This means that as a general rule, employees of small and recently established companies that are not necessarily involved in innovative activities will also be able to benefit under the concession.

It is also worth pointing out that the Draft Bill allows an employee to hold up to 10\% of the shares in the issuing company or control up to 10\% of the voting rights in the company. This may be contrasted with the maximum 5\% condition that exists in relation to the current reduction concession and deferred taxation arrangements. The purpose of having shareholding and voting restrictions has always been to focus the benefits of the ESS concessions on employees who have small or no interests in their employers so that employee share ownership can be more widely spread across the company. The proposed new rule in the Draft Bill therefore relaxes the requirements and is designed to ‘allow employees to obtain a greater ownership share in their employer’ while still ‘ensuring the fairness and integrity of the tax system’.\textsuperscript{140}

\textbf{Safe harbour valuation changes}

In its \textit{Industry Innovation and Competitiveness Agenda} report, the Government stated that it would make changes to the safe harbour rules for valuing unlisted rights to ensure ‘they reflect current market conditions’.\textsuperscript{141} In this regard, the Draft Regulations propose to replace the existing valuation tables in the ITAR 1997 with a new set of valuation tables. In addition, the Draft Bill proposes to provide the Commissioner with a new power to approve (by legislative instrument) methods for working out the market value of shares and rights acquired under an ESS.\textsuperscript{142} These measures are designed to help reduce compliance costs.

\begin{itemize}
  \item Draft Bill proposed s 83A-33(6).
  \item Although note that trading and investment companies are expressly excluded: Draft Bill proposed s 83A-45(3).
  \item Explanatory Materials, above n 29, 1.57.
  \item \textit{Industry Innovation and Competitiveness Agenda}, above n 9, 78.
  \item Draft Bill proposed s 960-412. A methodology that has been approved by the Commissioner will be binding so long as the taxpayer has complied with any relevant conditions.
\end{itemize}
The Government also foreshadowed in its *Industry Innovation and Competitiveness Agenda* report that it would implement administrative changes aimed at ‘streamlining’ the process companies will need to go through to establish and maintain their ESSs. The Government has tasked the ATO to work with industry to develop and approve standardised ESS documentation. ASIC will also be consulted on this reform as it has the role of overseeing disclosure documents relating to financial products.

10. Conclusion

Overall, the Government’s proposed changes to the ESS rules demonstrate a significant shift in policy and show that it has listened to key stakeholders, especially those from the start-up sector and venture capital industry. As with all tax reform, the ‘devil will be in the detail’ and the precise scope of the reforms will only be revealed after the consultation process has been concluded and the final version of the new legislation and regulations come into force. Nevertheless, as they currently stand, the proposed provisions contained in the Draft Bill and Draft Regulations constitute a meaningful change to the current and much criticised approach to taxing ESSs in Australia.

The reforms should go a considerable way to achieving the Government’s desired goal of facilitating ‘better alignment’ of the interests of employers and employees, and stimulating ‘the growth of high technology start-ups in Australia by helping small unlisted companies be more competitive in the labour market.’ They also have the potential to address the common concern raised in various studies that ESSs ‘are cumbersome to set up, and require a good deal of expensive professional help to comply with all of the regulations to which they are subject.’

The reforms should make Australia’s rules for taxing benefits under ESSs more competitive internationally and certainly bring them into line with the general practice adopted overseas, where options are not ordinarily taxed at the time of issue. In particular, the fact that specific concessions will be provided for ESSs established by start-up companies represents a major initiative as this will be the first time that the Government has purposefully carved out special rules for this important niche sector of the market. Entrepreneurial start-up companies, especially those engaged in high-tech scientific endeavours, are vital to Australia’s innovation system and for moving Australia forward as a leading knowledge-based economy in the 21st Century. If implemented, the reforms are likely to reinvigorate interest in

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143 *Industry Innovation and Competitiveness Agenda*, above n 9, 78.
145 Fryer and Abrahams, above n 7, 1.
146 For a broad general discussion of the way in which various foreign countries tax benefits under their specific schemes, see *The Treasury*, above n 6, 31-34.
ESSs by start-ups and should help them to cost-effectively hire and retain the staff they require to pursue their wide and varied innovation agendas. Although having effective ESS rules are only one small aspect of the overarching regulatory framework that supports Australia’s innovation system, it constitutes a particularly important element for start-up companies as it can assist with their liquidity issues, attract venture capital investment and enable them to more rapidly achieve the scale required to become financially successful.