[Insert DD Month YYYY]

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[Insert Client Name]

[Insert Client Position]

[Insert Company Name]

[Insert Client Address]

[Suburb State Post Code]

Dear [Insert Client Name]

**Re:** **Employee Share Scheme (ESS) taxation rules**

The current ESS rules are set out in Division 83A of the *Income Tax Assessment Act* 1997 (**ITAA 1997**) and apply to ESS interests acquired on or after 1 July 2009 (subject to certain transitional provisions applicable to such interests which were acquired before 1 July 2009). In addition, significant changes were made to the ESS rules effective from 1 July 2015 especially in respect of certain start-up companies.

**Executive summary**

1. If your company qualifies as a start-up, more generous taxation rules apply from 1 July 2015.
2. For all other companies, the general ESS rules apply subject to certain other changes made effective from 1 July 2015.

**Start-Up Rules**

In order to qualify as a start-up, the following conditions must all be met by a company:

* the employer and any members of its corporate group must not be listed on an approved stock or securities exchange at the end of its most recent year of income
* the employer and any members of its corporate group must be less than 10 years old
* it must have an aggregated turnover not exceeding $50 million for the most recent income year before the ESS interest was acquired
* it must be an Australian resident taxpayer.

If the company is an eligible start-up company any discount on the market value of any shares or rights will be treated as follows:

* a discount on a share in such a company will be tax exempt if the discount was less than 15% of the market value of the share when acquired, and the share will have a cost base equal to its market value when acquired rather than the amount paid for the share. Accordingly, the discount of up to 15% is never taxed but is taken to have been included in the share’s cost base for capital gains tax (**CGT**) purposes
* the discount on a right will not be subject to upfront taxation provided the exercise price is greater than or equal to the market value of the ordinary share in the company at the time the right was acquired. Thereafter, the right and any resulting share acquired will be subject to CGT when on-sold with a cost base equal to the employee’s cost of acquiring the right. There will be no CGT on the exercise of rights and the subsequent acquisition of shares. However, the exercise price of the rights will form part of the cost base of the resulting shares on any later disposal of the shares at a capital gain.

Such start-up companies must also meet certain other eligibility conditions applicable to all ESS. However, certain safe harbour valuation methods have been approved for the purpose of valuing an eligible start-up company as set out in *Income Tax Assessment (Methods for Valuing Unlisted Shares Approval 2015* (ATO Legislative Instrument 2015/SBIT/004).

For all other companies, the general rules on the taxation of ESS shares or rights described below will apply.

**General Rules**

Since 1 July 2009 employees have not been able to choose whether to be taxed upfront on any discount on the market value of an ESS share or right at a later time.

Accordingly, all ESS (excluding the start-up rules described above) default to being taxed upfront.

In these circumstances, the discount is included in the assessable income in the year in which the ESS share or right is acquired, being the market value of that ESS interest less any consideration paid or payable for the interest. Different valuation rules apply depending on whether the company is listed or not.

The employee will only benefit from deferred taxation in respect of a share issued under an ESS if:

* the ESS interest is subject to a real risk of forfeiture or
* the ESS interest is acquired under a salary sacrifice arrangement and the employee receives an ESS interest under that scheme whose market value does not exceed $5,000 at the time of acquisition under such an arrangement for a particular year.

Conversely, the employee will benefit from deferred tax in respect of a right issued under an ESS if:

* the ESS right is subject to a real risk of forfeiture (other than by disposing of it, exercising it or letting it lapse) or
* there is a real risk that if the right is exercised any beneficial interest in a share will be forfeited or lost (other than by disposing of it).

**Tax concession**

Employees who pay tax upfront on an ESS interest may be entitled to reduce any discount received on the market value of an ESS interest by up to $1,000 under a tax concession. However, the $1,000 tax concession is only available where the employee’s ‘income’ is $180,000 or less in the year in which the ESS interest was acquired.

For these purposes ‘income’ comprises the sum of the employee’s taxable income (including any ESS discount that would have had been assessable before applying this ESS concession), total reportable fringe benefits, reportable superannuation contributions, deductible personal superannuation contributions, total net investment loss and net rental property loss. However, any assessable FHSS released amount under the First Home Super Saver scheme is disregarded in calculating ‘income’ under the above test.

The above $1,000 discount on an ESS interest acquired under an ESS scheme will only be available where:

* the employee is employed by an ESS company or subsidiary and the ESS interest offered must relate to ordinary shares
* the employee is not allowed to dispose of the ESS interest for at least three years after acquiring the ESS interest unless the employee ceases to be employed before that time
* the ESS scheme is operated on a non-discriminatory basis in relation to at least 75% of Australian permanent resident employees of the employer with a minimum of three years’ service
* the issue of the ESS interest does not result in the employee holding a beneficial interest in more than 10 per cent of the shares or voting rights in the company
* where the ESS interest is a share there is no real risk of forfeiture of the share, or where the ESS interest is a right, there is no real risk of forfeiture of that right or the beneficial interest in shares where such a right is exercised.

**Real risk of forfeiture**

The facts and circumstances of each scheme and the individual circumstances will determine whether there is a real risk of forfeiture.

An ESS interest acquired by an employee will generally be considered to be at a real risk of forfeiture if a reasonable person would consider that there is a real risk that the employee may forfeit or lose the ESS interest, where the term 'real' in this context means something more than a mere possibility. In this regard, an ESS interest will not be at real risk of forfeiture if a reasonable person would disregard the risk as highly unlikely to occur or as being nothing more than a rare eventuality or possibility*.*

**Deferred taxation point**

If taxation of an ESS interest is deferred, an amount will be included in the employee’s assessable income for the year at the time that the deferred taxing point occurs, being the market value of the ESS interest at that time reduced by the cost base of that interest.

The relevant ESS scheme must satisfy the same eligibility conditions as those that apply to an ESS scheme where the upfront tax concession is obtained. Accordingly, the above rules limiting the scope of the ESS scheme to the issue of ordinary shares to an employee of a company or subsidiary must be met. In addition, the ESS interest being issued must have been made available to at least 75 per cent of Australian permanent resident employees with at least three years’ service and no employee can hold a more than 10 per cent beneficial interest in the relevant company.

Where the taxation of the discount on ESS shares is deferred, the deferred taxing point is the earliest of:

* when there is no real risk of forfeiture of the shares and any restrictions on sale are lifted
* when the employee ceases employment or
* 15 years after the shares were acquired.

For ESS rights the deferred taxing point is the earliest of:

* when there is no risk of forfeiture of the rights and any restrictions on the sale are lifted
* when the employee exercises the rights
* when the employee ceases employment or
* 15 years after the rights were acquired.

**Employer obligations**

Employers are required to report to the ATO details of any ESS interest issued to employees at a discount.

Employers must also issue an ESS statement which details the discount amounts and the corresponding label to be included in the employee’s individual income tax returns, including shares or rights acquired under the start-up concession.

The employer is also required to withhold tax at the effective highest marginal tax rate (being currently 47%) in relation to discounted shares or rights where the employee has not supplied a Tax File Number (TFN) (or in the case of an independent contractor an Australian Business Number (ABN)) to the employer by the end of the income year.

**Tax refunds**

A refund of tax paid in relation to ESS interest is available where:

* an amount of ESS discount has been, or would be, included in the employee’s assessable income
* the employee has subsequently forfeited the ESS interest (in the case of rights, the employee lost the right without disposing or exercising the rights)
* the forfeiture or loss is not a result of:
	+ the individual’s choice, except for when the choice was to cease employment or
	+ a provision of the scheme that has the direct effect of protecting the employee from a fall in the market value of the ESS interest.

There is no time limit on amending an assessment to exclude an amount from a taxpayer’s assessable income for a share interest which is forfeited, or for a right which was lost without being exercised.

If you have further queries on any details contained within this letter or on any other matter, please do not hesitate to contact me on [insert telephone number].

Yours faithfully

[Insert Name and Title]