
Cross-border issues arising from employee share ownership plans

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In 2009 the federal government introduced Div 83A into the Income Tax Assessment Act 1997 (Cth). The Division deals with taxation of employee shares and rights. The application of those rules and related provisions (such as the capital gains tax provisions) to cross-border employees is particularly complex. The complexity arises because the rules lack clarity, the transitional rules do not cover all possibilities and, in addition, the nature of employee share schemes means that they may be subject to tax at different times in more than one jurisdiction. This article starts with the premise that employee share schemes are different to other forms of remuneration. It considers how the rules might be applied and how the problem of double taxation might be dealt with.

INTRODUCTION

The provision of shares and options to employees under employee share ownership plans (ESOPs) creates particular issues where the employee works/provides services in more than one jurisdiction. At the country-to-country level, an issue can arise as to who should have taxing rights – the country in which the person is a resident or the country from which the benefits are sourced? From the employee's perspective the issue can be one of potential double taxation if both the residence and source jurisdictions seek to impose tax. In both cases the "solution" can be provided at the domestic level (by an exemption or credit for tax paid) and/or at the level of bilateral treaty negotiation (by allocation of the taxing right to the treaty countries). The purpose of this article is to identify the issues that can arise in more detail and to consider the solutions that apply in Australia. Although the domestic law and treaties deal with income from employment in some detail, ESOPs have some particular characteristics that make this type of remuneration more difficult to deal with in the usual way. In other words, there are significant differences between ESOPs and other income from employment.

It is becoming increasingly important to consider these issues for two reasons: first, remuneration trends favour non-cash benefits, such as shares and options, being provided especially to more senior executive employees.¹ This is seen as a way of aligning the interests of the shareholders of the company and the employees as well as providing longer term incentives to employees to perform. The second reason is the rapid increase in global mobility.

The article will consider the differences between ESOPs and other income from employment, highlighting why the issues relating to ESOPs are unique and may require different solutions. It will then consider the current domestic tax treatment of ESOPs and identify the particular issues that arise for employees in the cross-border situation. Next, the current domestic rules will be examined to see how they apply to Australian residents who work overseas and to foreign residents who work in Australia. The next section will consider the position under Australia's bilateral treaties as well as domestic relief from the possibility of double taxation for cross-border employees.

THE DIFFERENCE BETWEEN ESOPs AND OTHER INCOME FROM EMPLOYMENT

It is appropriate to start by considering how income from employment is taxed under the Australian income tax system. Cash payments for services that are in the nature of salary or wages are subject to tax under s 6-5 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) as "ordinary income". That

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¹ Productivity Commission, *Executive Remuneration in Australia*, Report No 49 (2009).

section is part of the “core rules” for tax and provides that if the taxpayer is an Australian resident, assessable income includes ordinary income derived directly and indirectly from all sources, whether in or out of Australia, during the income year.² If the taxpayer is a foreign resident, assessable income includes ordinary income derived from all Australian sources during the income year and other income that is included on some basis other than having an Australian source (for example, under the capital gains tax (CGT) provisions).³ Cash payments that are not salary or wages and non-cash benefits are excluded from ordinary income and are subject to fringe benefits tax (FBT) under the *Fringe Benefits Tax Assessment Act 1986* (Cth). This means that the tax on those benefits is borne by the employer at the top marginal tax rate. Non-cash benefits in the nature of shares and rights (such as options) provided to employees are not subject to FBT⁴ and are not taxed as employment benefits.⁵ Instead such benefits are dealt with by a special division within the ITAA 1997: Div 83A. Discounts in relation to such shares or options are included in assessable income under s 6-10 which deals with statutory income.⁶ If an amount can be both ordinary income and statutory income, the statutory provisions apply unless a contrary intention is found.⁷ In the absence of such a contrary intention, Div 83A applies rather than the ordinary income provision. The government has recently justified the different treatment for employee shares and options by saying that they are a way of aligning the interests of employers and employees and presumably therefore deserving of some concessions.⁸

There are several differences between the acquisition of shares or options as remuneration and the receipt of cash as salary or wages. These differences impact on the way the income is treated for tax purposes.

The first difference relates to when the benefit is taken to be derived for tax purposes. The concept of derivation is important in income tax law for a number of reasons. Section 6-5 (ordinary income) and s 6-10 (statutory income) both provide that assessable income includes an amount derived either directly or indirectly. One proposition is that an amount is included *if* derived and therefore without derivation an amount will not be income. An example of this proposition relates to gifts. It has been held that a gift that is not sufficiently connected to the performance of services will not be income.⁹ Another example relates to the principle that an amount must “come home” to the taxpayer so that a saving of expenditure will not be regarded as income.¹⁰ It might be argued that if a payment (or benefit) is provided subject to a contingency, no amount has been derived by the taxpayer until the contingency is met. Alternatively it might be argued that something has been received but the value is not clear. This issue is discussed below.

A second proposition is that assessable income includes an amount *when* received and so a person will not be subject to tax until the income is received. Salary and wages are derived when received whether the payment is for current or past services. However, in the case of shares and options there are different times when it could be said that a benefit has been received and therefore derived. This is especially so with the grant of an option to acquire shares.¹¹ For example, it could be said that a benefit is received upon grant of the option, upon vesting of the option, upon exercise, or when there

² ITAA 1997, s 6-5(1).

³ ITAA 1997, s 6-5(2).

⁴ Excluded from the definition of “fringe benefit”: s 136(1)(m) of the *Fringe Benefits Tax Assessment Act 1986* (Cth).

⁵ ITAA 1997, s 15-2(3)(e).

⁶ The term “discount” is not defined in the legislation. Under the previous legislation it was defined as the difference between the market value of the share or right less any consideration paid or given by the taxpayer: ITAA 1936, s 139CC.

⁷ ITAA 1997, s 6-25(3).

⁸ *Tax Laws Amendment (2009 Budget Measures No 2) Employee Share Schemes Act 2009* (Cth), Explanatory Memorandum at [1.25].

⁹ *Scott v FCT* (1966) 117 CLR 514.

¹⁰ *FCT v Cooke and Sherden* (1980) 10 ATR 696; 80 ATC 4140.

¹¹ Options can take different forms, for example, a right to acquire shares at a fixed point of time at a particular price (exercise price) (called an American option) or a right to acquire shares during a period of time at a particular price (called a European option).

are no restrictions on the sale of shares acquired as a result of exercise of the option. Similarly, shares may be granted subject to various performance or other hurdles. This means that there are a number of alternative times at which it is appropriate to say that a benefit has been derived where the income is in the form of shares or options. The question of whether income has been derived and, if so, when has been discussed in a number of cases. In the United Kingdom, the case of *Abbott v Philbin*¹² raised issues of derivation. In 1954, the taxpayer paid to acquire an option to purchase 2,000 shares in his employer at a fixed price being the market value at the time the options were granted. In 1956, he exercised the option and acquired 250 shares. The Revenue included an amount in his assessable income based on the difference between the exercise price and the market value in 1956. The House of Lords held by majority that no amount could be included as income in 1956 and also implied that any tax consequences arose only in 1954 when the option was granted. In 1974, the case of *Donaldson v FCT*¹³ also dealt with the assessability of options. Although the scheme in that case was structured using a trust and the employees had beneficial interests in convertible notes, the issue was essentially the same, that is, at what time (if any) did the employee derive income. The Commissioner argued that the interest acquired by the employee was assessable in the year the interest was granted and assigned an arbitrary value to the notes depending on the year in which the options were exercisable. The taxpayer argued that all he had initially was a future expectancy, that is, although he might acquire a benefit in the future he did not acquire any benefit at the time of grant of the interest. The court was not persuaded that the Commissioner's assessment was wrong and upheld the assessment. The government initially responded by introducing legislation that provided that the appropriate taxing point was when the options were converted to shares¹⁴ but also introduced some concessions to encourage the use of ESOPs. It was not until 1995 that the legislative position was changed to provide that the taxing point for options was the time at which the option was acquired.¹⁵ The current position in relation to taxation of ESOPs is discussed below but it is clear that opinions differ on if and when income is derived under an ESOP.

A second but related difference between shares and options and salary and wages is that employee shares and options are often contingent. They may be given subject to performance hurdles or to period of service or some other condition. Cash salary may also be subject, perhaps in part, to performance conditions such as an annual bonus dependant on performance. However, as the cash bonus is only subject to tax on receipt, there are no issues about trying to identify any benefit before the bonus is actually received. If the ability to exercise an option or to deal with a share is subject to a condition then there is an argument that until the condition is satisfied no benefit is derived. Professor Parsons argued that the grant of the right to acquire shares constitutes a derivation even though the right may be contingent or defeasible.¹⁶ The basis for this proposition appears to be that the right to acquire shares is a chose in action. A more practical problem is that if an amount is included in assessable income at the time of the initial grant, what is the position if the condition is not satisfied? One possibility is a refund of tax paid. The requirement to fulfil a condition also raises specific valuation issues – should the existence of the condition be taken into account in working out the value? The issue was raised in *Donaldson* because the notes could not be converted into shares until the employee had successfully completed each of three succeeding periods of satisfactory performance. Prior to completion of the period the rights were contingent. The court did not really consider the point except to say that this might influence the amount that a purchaser might be willing to pay for the interest. In saying that the interest was assessable when received, the court appeared to accept that something of value was received. Since 1995 the legislative position has also been to disregard any contingencies both with respect to when tax is imposed and also with respect to the

¹² *Abbott v Philbin* [1961] AC 352.

¹³ *Donaldson v FCT* [1974] 1 NSWLR 627; (1974) 4 ATR 530.

¹⁴ Former s 26AAC of the ITAA 1936.

¹⁵ ITAA 1936, s 139B.

¹⁶ Parsons RW, *Income Taxation in Australia* (Law Book Co., 1985) at [11.60].

value of the interest.¹⁷ The legislation also contains limited opportunities for obtaining a refund of tax paid where rights are lost in certain circumstances.¹⁸

A third significant difference between cash salary and benefits in the nature of shares and options relates to valuation generally. What is the appropriate value to place on such benefits? Although the answer generally adopted is the current market value,¹⁹ this can be problematic in the case of shares and options that are not listed on a securities exchange because the absence of a market means that some sort of individual valuation exercise is required and this can be costly. Options that may or may not be exercised depending on the market value of the underlying shares present particular problems. Further, there is a real issue about whether any restrictions imposed on the shares or options affect their value. Clearly from a market perspective, any restrictions on disposal will affect the price a person would be prepared to pay, yet the legislation specifically directs that such restrictions not be taken into account in valuing shares or options for tax purposes.²⁰ A feature of the FBT legislation is that it adopts different valuation rules for different types of benefits. In some cases this is simply the cost, in some cases market value and in some cases a formula is used that may or may not capture the full value (for example, cars). However, none of these benefits has the same difficulties associated with valuation as shares and options, particularly where there is no identifiable market.

Another difference that can arise is that sometimes shares and options are not granted as remuneration for services but instead in return for some contribution to a start-up business. This is often the case with start-up entities in emerging industries where the ability to pay cash salaries is limited and the individual is prepared to contribute intellectual or other property to the business in exchange for equity in the business. In these situations it has been suggested that it is not appropriate to treat the shares and options as remuneration for services but rather as a payment for capital.²¹

The fact that there are significant differences between the receipt of shares and options and other income from employment is sufficient to justify separate tax treatment even at the domestic level. The next section traces the development of the tax treatment of ESOPs generally before considering the tax treatment of cross-border employees.

TAX TREATMENT OF ESOPs

Prior to 1974, there was no legislation dealing with taxation of employee shares and options and so the matter was dealt with under general rules. At that time employment benefits could either be "ordinary income" or subject to tax under s 26(e) of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). At that time the fact that shares and options were subject to restrictions on transferability probably meant that they could not be ordinary income (on the basis that they were non-convertible to money). The Commissioner did, however, seek to assess such benefits under s 26(e). That section provided that assessable income included the value to the taxpayer of any benefits received directly or indirectly in relation to any services rendered. The Commissioner was successful in having similar benefits included as assessable income in the case of *Donaldson* (discussed above) in relation to convertible notes (similar to options) despite the arguments of the taxpayer concerning the future nature of the interest, the conditions attached to full control and the difficulties of valuation.

Donaldson's case gave rise to concerns about the appropriateness of taxation at the time of grant of options and legislation was introduced to overcome the result of the case. The main point of s 26AAC of the ITAA 1936 was to set a taxing point that identified the acquisition of shares as the time for tax liability. That is, the acquisition of the option was no longer a taxing point. Tax was only

¹⁷ ITAA 1936, s 139FD.

¹⁸ ITAA 1997, s 83A-310 (discussed below).

¹⁹ The term "market value" is defined in the legislation (ITAA 1997, Subdiv 960-S). Section 83A-315 provides that the regulations may specify an amount other than market value.

²⁰ ITAA 1997, s 960-410.

²¹ See Rider C, *Sellers of Labour or Investors of Intellectual Capital?*, IPRIA Working Paper 19/05 (October 2005).

imposed when the option was exercised and a share acquired. The legislation also introduced a limited concession to encourage the granting of shares and options to employees provided that the shares or options satisfied certain conditions.

The introduction of FBT in 1986 was an opportunity to include shares and options as another form of non-cash benefit but this was not done. In the 1994 Budget, the government announced that it would remove employee share schemes (ESSs) from the income tax and insert them into the FBT legislation. This included the preparation of draft legislation²² but ultimately the government decided to leave the rules in the income tax legislation but to rewrite them.

In 1995, a more comprehensive regime, Div 13A, was introduced into the ITAA 1936. Broadly, the approach was similar to s 26AAC although some loopholes were closed. One significant difference was that the legislation identified the taxing point for all shares and rights as the time of receipt²³ – that is, the taxing point for options was brought forward.²⁴ Tax was imposed if shares or right were acquired in respect of services – that is, whether an employment relationship existed or not.²⁵ The legislation also distinguished between “qualifying” and “non-qualifying” shares and rights²⁶ and provided two mutually exclusive concessions for qualifying shares or rights. The first concession was a tax exemption of \$500 worth of discount per employee per year (increased to \$1,000 per annum in 1997). The second concession was deferral of tax for up to 10 years for qualifying shares or rights in certain cases. It was possible, however, to elect to be taxed on receipt²⁷ and this became an attractive option because it allowed subsequent gains to be taxed under the CGT regime and so to benefit from the 50% CGT discount available to individuals from 1999.²⁸ In order to be eligible for either the deferral concession or the exemption concession the scheme had to satisfy a number of conditions including the existence of an employment relationship, restrictions on the type of interests that could be acquired (only ordinary shares or rights to acquire ordinary shares) and restrictions on the amount of equity that could be acquired (generally 5%).²⁹

In 2009, the government announced significant changes to the tax treatment of ESOPs. There were two main changes: a much more limited ability to defer and the restriction of the exemption concession to those with taxable incomes of \$60,000 (subsequently raised to \$180,000).³⁰ The changes which were initially announced in the 2009 Budget were unexpected and took the business community unawares. A number of companies announced that their ESSs were on hold.³¹ The government undertook some public consultation³² and as a result introduced amended legislation.³³

Under Div 83A of the ITAA 1997, the default position is that shares or rights received in respect of the provision of services will be subject to tax on receipt. The legislation still distinguishes between shares and rights that qualify for concessions but no longer uses the terminology of “qualifying” shares or rights. The concessions are still either an exemption (renamed as a reduction concession) or a deferral concession but eligibility for the concessions has changed. Under Div 83A the reduction

²² Burgess P, Cooper G, Krever R, Stewart M and Vann R, *Income Taxation: Commentary and Materials* (6th ed, Thomson Reuters, 2009) at [4.620].

²³ ITAA 1936, s 139B(1).

²⁴ See now ITAA 1997, s 83A-20(2).

²⁵ ITAA 1936, s 139C(1).

²⁶ ITAA 1936, s 139CD.

²⁷ ITAA 1936, s 139E. Until 2008/2009, the election could be made some time after the acquisition and this allowed taxpayers to make the election where the shares had increased in value.

²⁸ ITAA 1997, Div 115.

²⁹ ITAA 1936, s 139CD.

³⁰ The Treasurer, *Better Targeting the Employee Share Scheme Tax Concessions*, Press Release No 63/2009 (12 May 2009).

³¹ Editorial, “Labor’s Share Schemes Blunder”, *Australian Financial Review* (19 May 2009).

³² Treasury Department, *Reform of the Taxation of Employee Share Schemes*, Consultation Paper (5 June 2009).

³³ Introduced into Parliament as the *Tax Laws Amendment (2009 Budget Measures No 2) Employee Share Schemes Act 2009* (Cth).

concession is now only available to those whose "adjusted" taxable income is less than \$180,000. This includes the amount of discount that is potentially exempt as well as reportable fringe benefits, superannuation contributions and any net investment loss. The ability to defer tax on receipt of shares or rights is no longer a matter of election for the employee but depends on the whether the scheme satisfies certain criteria.

The objects of the Division are stated to be:

- that such benefits are subject to income tax (and not subject to FBT law); and
- to increase the extent to which the interests of employees are aligned with those of their employer, by providing a tax concession to encourage middle and low income earners to acquire shares under such schemes.³⁴

The provisions of Div 83A will now be dealt with in more detail.

DIVISION 83A OF THE ITAA 1997

Division 83A provides that discounts on shares and rights acquired under an ESS are included in assessable income.³⁵ Although not specifically spelt out, the discount amount is the "market value" of the shares or rights less any amount paid or to be paid to acquire them.³⁶

An ESS is defined as a scheme under which "ESS interests" are provided to employees (or associates) (including past or prospective employees) of the company or a subsidiary in relation to an employee's employment.³⁷ The position in relation to an associate of the employee is similar to Div 13A although it is now possible for deferral to be available even if the shares or rights are acquired by an associate.³⁸ Under s 26AAC of the ITAA 1936, it was actually possible to split income because if an associate of the employee was provided with shares or rights, the associate was liable to tax.³⁹ Division 13A changed the position so that shares or rights provided to an associate were included in the assessable income of the employee.⁴⁰ The inclusion of past or future employees brings the position in line with the FBT regime⁴¹ which has always applied where benefits are provided before employment or after the employment has ended. The Division also extends to persons other than employees. The most significant of these is an individual who "provides services ... other than as an employee", which, according to the Explanatory Memorandum (EM), includes independent contractors. Under Div 13A the receipt of shares or rights by a service provider (whether an individual or an entity) gave rise to a liability to tax but no concessions were available. It appears that under Div 83A, independent contractors can access concessions as the relevant provision states that the Division applies to such an individual as if he or she were employed by the entity and the provision of services is treated as employment.⁴² In order to access the concessions under Div 83A, the individual must be in an employment relationship with the company or a subsidiary.⁴³ However, it appears that this could be satisfied by a person providing services even though this may not have been intended. This extension to independent contractors seems sensible but it is clearly a departure from the previous position. The rules also apply where the payer has Pay As You Go (PAYG) obligations, for example, in relation to directors who might not otherwise be regarded as employees. There is also an express provision for "foreign service" which is relevant to cross-border employees and is discussed below.

³⁴ ITAA 1997, s 83A-5.

³⁵ ITAA 1997, s 83A-25.

³⁶ Explanatory Memorandum, n 8 at [1.102].

³⁷ ITAA 1997, s 83A-10.

³⁸ Explanatory Memorandum, n 8 at [1.273]; see also ITAA 1997, s 83A-305.

³⁹ Former ITAA 1936, s 26AAC(5).

⁴⁰ ITAA 1936, s 139D.

⁴¹ Definition of "employee" in s 136(1) of the *Fringe Benefits Tax Assessment Act 1986* (Cth).

⁴² ITAA 1997, s 83A-325.

⁴³ ITAA 1997, s 83A-35(3).

The rules apply when a person acquires an “ESS interest”. An ESS interest is defined as a beneficial interest in a share or a right to acquire a beneficial interest in a share.⁴⁴ This means that if shares are held by a trust for an employee, the employee will be subject to tax as though he or she is the legal owner. The Division also contains rules for identifying assets when they are held in a single pool.⁴⁵ It also applies to stapled securities provided at least one of the stapled interests is a share in a company and the share is an ordinary share.⁴⁶ This repeats the position under the previous legislation that had been changed in 2007 in response to market pressure relating to interests in property trusts.⁴⁷ An attempt has also been made to include certain rights which are indeterminate, that is, it is unclear whether an ESS interest will be received or how many ESS interests will be received.⁴⁸ An example from the EM recognises such indeterminate rights are not yet ESS interests but provides that when any such rights become clear they will be treated as having been received at the earlier time. The example provides as follows:

Oscar is granted a right to shares in his employer, Stonework Co, as a part of his total employment remuneration package. Oscar will receive 200 Stonework Co shares in two years time, provided he meets certain performance hurdles. However, Stonework Co management reserves the right to grant Oscar the cash value of the shares rather than actual Stonework Co shares.

Oscar meets his performance hurdles, and Stonework Co management exercises its discretion to grant the value of the shares in cash. He does not have any ESS interests, and will not be taxed under the employee share scheme rules.

This income will be assessed under other provisions in the tax law.⁴⁹

One matter that is not addressed is whether such rights might be fringe benefits and therefore subject to tax at an earlier time. However, the Commissioner has taken the view that FBT does not apply.⁵⁰

The amount to be included in assessable income is referred to as the “discount” given in relation to the interest.⁵¹ Under Div 13A the discount was defined as the market value of the share or right at the time of acquisition less any consideration paid or given for the acquisition of the right.⁵² Under Div 83A there is no definition of the term “discount” but it is provided that the regulations may specify an amount to be used instead of market value and that that amount may be used in working out the discount.⁵³ One of the long-standing difficulties associated with ESOPs is the difficulty of valuing shares and rights. The difficulties arise because the shares or rights often have conditions or restrictions attached (which affects market value) and because shares and rights that are quoted on a securities exchange appear much easier to value than unquoted shares and rights. Division 13A had a number of sections that dealt with market value for listed and unlisted shares and rights. Those rules have not been included in Div 83A although the rules for determining the market value of unlisted options are reproduced in the Regulations. According to the EM, this is a deliberate change of approach and taxpayers now have a choice to rely on the ordinary meaning of the term “market value” or to adopt the methodology set out in the Regulations. The EM suggests that the ordinary meaning provides increased flexibility as taxpayers can choose the valuation methodology that fits their

⁴⁴ ITAA 1997, s 83A-10(1).

⁴⁵ ITAA 1997, s 83A-320.

⁴⁶ ITAA 1997, s 83A-335.

⁴⁷ ITAA 1936, ss 139DSA-139DSI.

⁴⁸ ITAA 1997, s 83A-340.

⁴⁹ Explanatory Memorandum, n 8 at [1.370], Example 1.58.

⁵⁰ The Commissioner has taken the view in the past that where a right is conditional and subject to the employers discretion it was not a “right” under the former Div 13A: see CR 2006/101 (the BHP-Billiton Ruling) and CR 2006/103 (the Brambles Ruling). See ATO, *Fringe Benefits Tax Employee Share Scheme: Indeterminate “Rights” Not Fringe Benefits*, TD 2010/142 (24 June 2010) which confirms that indeterminate rights are not fringe benefits.

⁵¹ ITAA 1997, s 83A-25(1).

⁵² ITAA 1936, s 139CC.

⁵³ ITAA 1997, s 83A-315.

circumstances. Subdivision 960-S contains some rules about “market value” and in particular states that anything that would prevent or restrict conversion of the benefit to money should be disregarded.⁵⁴ In view of the difficulties associated with valuation of such interests, the Board of Taxation was asked to consider the issue of market value, in particular the position of listed securities as well as unlisted securities (shares and rights).⁵⁵ The Board released its report in February 2010 which contained the following recommendations:

- For securities that are traded on a listed market (shares and options), the best approach is to require valuation in accordance with the ordinary meaning of market value. However, the Board suggested that this be supplemented by guidance from the Commissioner of Taxation on acceptable methodologies for valuing listed securities.
- For unlisted shares, the Board took a similar approach also noting that participants would benefit from further guidance as to acceptable valuation practices.
- For unlisted rights, the Board favoured the retention of a “safe harbour” methodology of valuing rights at the greater of their intrinsic value or the value derived under the statutory valuation tables. It was also recommended that the assumptions underpinning the statutory tables be reviewed from time to time and that the assumptions be made publicly available. It was further recommended that the Australian Taxation Office (ATO) develop an online calculator tool to enable taxpayers to value their unlisted rights.⁵⁶

The default position under Div 83A is that discounts are included in assessable income in the year in which the shares or rights are acquired⁵⁷ but there are two “concessions”. First, it is possible to have the amount included in assessable income reduced (this replaces the previous exemption concession). Secondly, there is a more limited opportunity to defer tax.

Reduction: An individual who acquires ESS interests may be eligible for a reduction in assessable income of up to a maximum \$1,000.⁵⁸ In order to be eligible for the reduction the individual’s adjusted taxable income must not exceed \$180,000. The additional amounts are the value of any discount; reportable fringe benefits, reportable superannuation contribution and total net investment losses (that is where expenses exceed income from investment).⁵⁹ This information will not always be available to the employer and clearly requires each individual employee to make a calculation as to whether the reduction is available. There are also a number of conditions to be satisfied which broadly duplicate the qualifying conditions in the previous legislation as well as other conditions required for exemption. Those conditions are as follows:

- The taxpayer must be employed by the company providing the shares or rights or a subsidiary.⁶⁰ This suggests that an actual employment relationship must exist for the concession to apply. However, as previously noted, s 83A-325 states that the rules of the Division extend to, inter alia, service providers, which suggests that, unlike the position under Div 13A, contractors can qualify for the reduction. If this was not the intention, the matter requires clarification. There had been some criticism of the previous legislation that the requirement that shares or rights must be in the employer or a subsidiary was too restrictive and calls were made for the relationships to be extended to include joint venturers or other related entities.⁶¹ This has not been done.

⁵⁴ ITAA 1997, s 960-410.

⁵⁵ Board of Taxation, *Review into Elements of the Taxation of Employee Share Scheme Arrangements*, Report to the Assistant Treasurer (February 2010), Terms of Reference.

⁵⁶ Board of Taxation, n 55. The government has indicated that it accepts these recommendations: Assistant Treasurer’s Department, Press Release No 73/2010 (23 April 2010).

⁵⁷ ITAA 1997, ss 83A-15, 83A-25(1).

⁵⁸ ITAA 1997, s 83A-35.

⁵⁹ Often referred to as “negative gearing”.

⁶⁰ ITAA 1997, s 83A-35(3).

⁶¹ House of Representatives Standing Committee on Employment, Education and Workplace Relations, *Shared Endeavours – An Inquiry into Employee Share Ownership in Australia* (2000) (Shared Endeavours).

- The taxpayer must receive ordinary shares.⁶² There have been calls to permit other types of shares but according to the EM other types of shares have less risk and will not therefore align the interests of employer and employee. The rules do provide for stapled securities providing at least one of the securities is an ordinary share and this duplicates the previous position.
- The ESS and any financial assistance under the scheme must be non-discriminatory to at least 75% of permanent employees.⁶³ Under the previous legislation, the term “non-discriminatory” was defined as requiring three conditions to be satisfied: participation had to be open to at least 75% of permanent employees; a reasonable time for acceptance had to be allowed; and the essential features of the offer had to be the same. Surprisingly, the term has not been defined in Div 83A. There was also a definition of “permanent employee” that referred to full-time and part-time employees⁶⁴ but there is no equivalent in Div 83A.
- There must be no risk of forfeiture of the share or right under the conditions of the scheme. This was also a requirement for exemption under Div 13A.⁶⁵
- The ESS interests must be held for a minimum period: the earlier of three years or when employment ceases. This was also a requirement for exemption under Div 13A. According to the EM, this is important to align the interests of the employer and employee.⁶⁶
- There is a 5% limit on beneficial shareholding and voting power. This was also required for shares or rights to be qualifying under Div 13A. The EM states that if an employee holds or controls more than 5%, the interests of the employee and the employer are already aligned and there is no need for any concession.⁶⁷ This condition does not apply if an employee is issued with options that potentially give rights to hold or control more than 5% of the shares in the company (unless the employee already holds shares). This is because the subsection refers to the position immediately after the ESS interest is acquired and at that time the option holder is not the holder of shares or in a position to control the voting power with respect to the share.⁶⁸
- Finally, there is an integrity rule that requires that the individual will not be eligible if employed by a company whose predominant business is the acquisition, sale or holding of shares. This is said to prevent schemes that are contrived to provide employees with interests in unrelated companies, through the establishment of share trading companies within the company group.⁶⁹

Deferral: The ability to defer tax is more limited than under the previous legislation. A significant difference is that it is no longer a matter of the taxpayer to elect whether to defer or pay tax upfront but depends on the scheme rules.⁷⁰ Deferral of tax is not available if the reduction concession applies.⁷¹ This is consistent with the previous law so that taxpayers are entitled to only one concession per scheme. In order to qualify for deferral, the scheme must satisfy a number of conditions and there must either be a real risk of forfeiture or the shares must be acquired under an eligible salary sacrifice arrangement (SSA).

The relevant conditions include some of those that are required for the reduction concession – the existence of an employment relationship, the requirement that the shares or rights relate to ordinary shares, the company must not be a share trading company, and the limitation on shareholding and

⁶² See ITAA 1997, s 83A-35(2) and (4); Shared Endeavours, n 61; Explanatory Memorandum, n 8 at [1.121]. The rules relating to stapled securities were introduced in 2006.

⁶³ ITAA 1997, s 83A-35(6).

⁶⁴ ITAA 1936, s 139GB.

⁶⁵ See ITAA 1997, s 83A-35(7); ITAA 1936, s 139CE(1).

⁶⁶ See ITAA 1997, s 83A-35(8); ITAA 1936, s 139CE(3); Explanatory Memorandum, n 8 at [1.131].

⁶⁷ See ITAA 1997, s 83A-35(9); ITAA 1936, s 139CD; Explanatory Memorandum, n 8 at [1.134].

⁶⁸ This was also the position under ITAA 1936, Div 13A, s 139CD.

⁶⁹ ITAA 1997, s 83A-35(3). This was also the case under ITAA 1936, Div 13A, s 139DF; Explanatory Memorandum, n 8 at [1.322].

⁷⁰ Explanatory Memorandum, n 8 at [1.38].

⁷¹ ITAA 1997, s 83A-105(1).

voting rights of 5%.⁷² There is also an additional condition where the ESS interests are shares – that at least 75% of permanent employees are entitled to acquire interests under the scheme or under another employee share scheme.⁷³ The section heading states “Scheme must be non-discriminatory” but the condition itself is more about broad availability rather than non-discrimination. The condition does not apply where the ESS interests are rights and can also be satisfied if ESS interests are available to other employees under another scheme (as was the case under Div 13A). This would appear to allow an employer to have one scheme that is broadly available and another (perhaps more generous) scheme that is only available to a limited group of employees (such as senior executives). It also means that option-type schemes do not have to be broadly available.

One way of qualifying for deferral is if under the scheme there is a real risk of losing the ESS interest, other than by disposing of it.⁷⁴ This is a more onerous requirement than under Div 13A which provided a taxing point when either restrictions on disposal or conditions of forfeiture ceased to have effect. Under Div 83A it will be necessary to show that there is a real risk that the interest may be lost. The EM contains extensive discussion of what constitutes a “real risk” and suggests that if the risk is “contrived” or is within the control of the employee, the requirement will not be satisfied. In most cases it suggests that whether there is a real risk of losing the interest will be a question of fact and circumstance.⁷⁵

An alternative way of qualifying for deferral is if the ESS interest is a share, the interest is provided under an arrangement referred to as a SSA and the total market value of the interests acquired in the employer or any holding company of the employer under a scheme in that year is \$5,000.⁷⁶ This is a new provision and appears to have been included to enable some existing arrangements to continue.⁷⁷

The relevant taxing point under deferral depends on whether the taxpayer acquires shares or rights.⁷⁸ In both cases this will be when any restrictions or conditions of forfeiture are lifted, when employment ends, or at the end of seven years. In the case of shares this will also occur on disposal of the shares if this occurs within 30 days of the restrictions being lifted or the employment ending. In the case of rights this will also occur on disposal of the interest other than by exercising it or on disposal of a share acquired as a result of exercise of the right if that disposal occurs within 30 days of the restrictions being lifted or the employment ending.

The amount to be included under deferral is the market value of the interest at the deferred taxing point less the cost base of the interest.⁷⁹ This represents a change from the previous position where what was included was the difference between market value and the amount paid to acquire the interest.⁸⁰

Ideally Div 83A would tax the gains made by employees on the acquisition of shares or rights and the CGT provisions would apply on disposal of the shares, including shares acquired as a result of exercising rights. However, as a result of the rules that deal with deferral there is a real possibility that all gains (including gains on disposal) will be taxed as income gains under Div 83A. This has been the subject of some criticism because, since 1999, certain capital gains made by individuals have been eligible for the CGT discount. Where the CGT rules⁸¹ do apply (for example, where the acquisition is

⁷² See ITAA 1997, s 83A-35(3)-(5), and (9).

⁷³ ITAA 1997, s 83A-105(2).

⁷⁴ ITAA 1997, s 83A-105(3); see also ITAA 1936, ss 139CA-139CB.

⁷⁵ Explanatory Memorandum, n 8 at [1.158].

⁷⁶ ITAA 1997, s 83A-105(4).

⁷⁷ Explanatory Memorandum, n 8 at [1.174].

⁷⁸ ITAA 1997, s 83A-115(1)-(4).

⁷⁹ ITAA 1997, s 83A-110. Explanatory Memorandum, n 8 at [1.141], [1.149].

⁸⁰ ITAA 1936, s 139CC.

⁸¹ ITAA 1936, ss 130-80 to 130-90.

taxed upfront or where the disposal occurs more than 30 days from the other cessation events), it is important to note that the relevant cost base will be the market value rather than the amount actually paid to acquire the shares or rights.⁸²

In certain cases an employee may pay tax on shares or rights but ultimately forfeit them. Under Div 13A an employee was only eligible for a refund of tax on forfeited rights (not shares) and only if the employee lost the right without having exercised it. Under Div 83A the employee could be entitled to a refund of tax paid in relation to both shares and rights.⁸³ However, the right to refund is fairly limited and does not apply where the forfeiture or loss is as a result of a choice made by the individual or where a condition of the scheme has the effect of protecting the individual against a fall in the market value of the interest.⁸⁴

The Division also deals with a number of other matters such as the availability of a deduction for the employer⁸⁵ and the rollover rules to be applied where there is a 100% takeover of the employer company.⁸⁶ There is also a new Division that imposes reporting requirements on providers of interests under ESSs. The employer must provide information to the Commissioner and to the employee at the time the interest is acquired and when a deferred taxing point occurs. The information must include an estimate of the market value of the interest.⁸⁷

Div 83A purports to apply to both Australian residents and foreign residents. It now contains a source rule and then relies on the core rules to exclude the foreign-sourced income of foreign residents from Australian income tax. This means that foreign residents will be subject to tax on Australian sourced income under Div 83A. Foreign residents are generally not subject to Australian tax on capital gains.⁸⁸ However, they may be subject to tax under Div 83A if they dispose of the interests within 30 days of an event under deferral. The position of temporary residents is dealt with under Div 768. Those rules seek to treat temporary residents as foreign residents in relation to certain foreign source income and capital gains. The exemption for foreign sourced income does not include "remuneration for employment undertaken or services provided while a person is a temporary resident". The specific reference to ESS interests has been removed and the EM suggests this is because the general language is sufficient to cover this type of receipt. Gains received by a temporary resident are treated in the same way as for foreign residents and so if the disposal is taxed as an income receipt under Div 83A, the gain will be subject to tax. The position of cross-border employees (individuals who work in more than one country) under Div 83A is considered in more detail below.

ISSUES FOR CROSS-BORDER EMPLOYEES

There appear to be at least three key issues for cross-border employees. The first relates to timing issues, that is, different countries may impose tax at different times resulting in the possibility of double taxation (timing mismatch). The second relates to the difficulty of identifying the service to which the shares or options relate (identification of relevant service) and the third relates to the fact that different countries may characterise the receipt either as income or as a capital gain (the characterisation issue).

Timing mismatch

Because most countries apply the same core rules for taxation based on residence and source, there is clearly a possibility of double taxation – an Australian resident who performs services in another country will be taxed in that other country on the basis of source and in Australia on the basis of

⁸² ITAA 1997, s 83A-30.

⁸³ ITAA 1936, s 139DD; ITAA 1997, s 83A-310. See also ITAA 1936, s 170(10AA).

⁸⁴ ITAA 1997, s 83A-310(c)(i) and (ii).

⁸⁵ ITAA 1997, Subdiv 83A-D.

⁸⁶ ITAA 1997, s 83A-125.

⁸⁷ *Tax Administration Act 1953* (Cth), s 392-5(3)(e)(iii).

⁸⁸ ITAA 1997, Div 855.

residence. A foreign resident who performs services in Australia will be taxed in his or her home jurisdiction on the basis of residence and in Australia on the basis of source. In some cases the double taxation will be relieved by domestic exemptions or credits; for example, in Australia there is a limited exemption for employment income (see below) but there are also foreign tax credits so that an Australian resident working overseas and subject to tax in the source country will generally be entitled to a credit for the tax paid in the other jurisdiction. Double tax agreements (DTAs) will also potentially apply. The different ways of providing relief from double taxation are considered in the next part. Although double taxation can potentially occur for all forms of employment income it is more likely to occur for ESS benefits for two reasons: one is that ESS benefits are often taxed at a different time to when the services are performed and also because different countries may adopt different approaches to the appropriate time to impose tax. Another difficulty is that where employment services are provided in more than one country it is not clear how the taxing rights should be allocated. It is also possible that an employee could have multiple residences during the life of the ESS and the DTAs do not really address this type of double taxation.⁸⁹

Identification of relevant service

It is also often not clear whether the benefit given under an ESS relates to past or future services. In some cases this can be determined from the terms of the scheme; for example, if shares or rights are given provided employment is maintained for three years, it seems clear that the benefit relates to the future employment. However, it may be that there is no condition requiring further services be provided but the benefits cannot be disposed of for a period of three years. In some cases it may be clear that the benefits are given with respect to and in recognition of past services. According to the Organisation for Economic Co-operation and Development (OECD) Report, the default position should be that the benefits relate to future service but that individual cases may require a different conclusion.

Characterisation issue

Another issue that can give rise to tax implications for cross-border employees is the fact that some countries view all of the gains arising from ESS benefits as employment income and other countries view the gain, or at least part of the gain, as a capital gain.⁹⁰ As already noted, Div 83A treats the gains as employment income including where the shares or rights are disposed of within 30 days of some other deferral event.⁹¹ In the domestic context this is significant for two reasons: first, capital gains arising from the disposal by resident individuals of assets held for more than 12 months can take advantage of the CGT discount that means that only 50% of the gain is included in assessable income.⁹² Shares or rights acquired under an ESS will not qualify for the discount where they are disposed of within the 30-day period. Secondly, foreign residents and temporary residents are generally only subject to tax on disposal of real property⁹³ and not on the disposal of ESS benefits unless Div 83A applies. This means that foreign residents have a significant tax advantage over Australian resident employees. Given that different countries take different approaches to this issue, cross-border employees may have additional issues. If the gain or part of the gain is considered to be capital then, in determining which country has taxing rights, it will be necessary to consider the Article dealing with capital gains⁹⁴ rather than that dealing with employment income. Generally those Articles give taxing rights to the country of source but the rules for determining source are different to those applying to employment income and in particular will not depend on the period of

⁸⁹ OECD, *Cross-border Income Tax Issues Arising from Employee Stock Option Plans*, Report approved by the Committee on Fiscal Affairs (23 August 2004) (OECD Report).

⁹⁰ OECD Report, n 89.

⁹¹ ITAA 1997, s 83A-115.

⁹² ITAA 1997, Div 115.

⁹³ ITAA 1997, ss 855-10 (residents) and 768-915 (temporary residents).

⁹⁴ OECD *Model Tax Convention*, Art 13.

employment.⁹⁵ An example of mixed characterisation was dealt with in ATO IDs 2007/173 and 2007/174.⁹⁶ An employee had been a resident of the United States at the time of being granted employee options with the American employer. At the time of exercise the employee had moved to Australia and become an Australian resident. The United States was entitled to tax the gain made on the exercise of the options and Australia was obliged to provide credit relief against the liability to CGT in Australia.

POSITION OF CROSS-BORDER EMPLOYEES UNDER DIV 83A

Prior to 2005, there were no specific measures dealing with the acquisition of shares or rights under ESSs in cross-border situations. The report of the Board of Taxation (Review of International Tax Arrangements) and the EM to the *New International Tax Arrangements (Foreign-Owned Branches and Other Measures) Act 2005* (Cth) (NITA Act) spoke of the need to attract skilled workers to Australia and to ensure a fairer and more certain outcome for relevant individuals.⁹⁷ The Board of Taxation noted that different countries tax such benefits differently and that this is particularly the case with options. Differences relating to the timing of tax, which could be on acquisition, exercise or disposal; identification of the employment to which the benefit applies, for example, past employment or future employment; and also on the issue of characterisation, that is, whether the gain is an income gain or a capital gain or a mixture of both. Some of the uncertainties identified included that the general principle that a foreign resident is not taxable on foreign source income was uncertain for employee shares and rights and could result in double taxation, and that if rights were acquired offshore but employment was subsequently performed in Australia the income benefit attributable to that employment may not be subject to tax in Australia (nil taxation). It was also noted that shares or rights held at the time of entering Australia would also not qualify for any concessions. There was also an inability to claim exemptions and credits for employee shares and rights because they were not treated as employment income. A further issue was that it was not clear whether s 23AG of the ITAA 1936 (as originally drafted) applied to shares or options acquired as a result of foreign service.

The Board took the view that it was necessary to deal with the matter comprehensively and formally through treaty negotiations. However, it noted that this would take a prolonged period of time and in the short term it recommended that Australia should change its domestic law to ensure that double taxation did not occur.⁹⁸ In particular, it noted that such measures should:

- give Australia the right to tax the appropriate amount commensurate with the employee's temporal connection with Australia;
- aim for closer alignment with the tax treatment of employee income both in Australia and overseas; and
- simplify tax provisions in line with those of major trading/investing partners.

The NITA Act in 2005 introduced some new measures into Div 13A. First, it provided that the portion of the discount that related to foreign service when the person was a non-resident would not be included in assessable income.⁹⁹ Secondly, it provided that individuals who acquired employee shares or rights offshore and then later become Australian employees (as defined) would apply the taxing provisions from the time he or she became an Australian employee.¹⁰⁰ There were also amendments to

⁹⁵ *Australian Machinery & Investment Co Ltd v DFCT* (1946) 180 CLR 9; 8 ATD 81.

⁹⁶ ATO, *Employee Share Options: Foreign Tax Credit Relief to an Australian Resident Taxpayer Where an Employee Share Option Benefit is Taxed by the United States*, ID 2007/173 (28 August 2007); ATO, *Employee Share Options: Taxing Rights on Gain from Sale of Shares by an Australian Resident Taxpayer Where the Options to Purchase Those Shares Were Granted to the Taxpayer When They Were Working in the United States of America*, ID 2007/174 (28 August 2007).

⁹⁷ Board of Taxation, *Review of International Tax Arrangements* (2005) Ch 5, p 135; Explanatory Memorandum to the *New International Tax Arrangements (Foreign-owned Branches and Other Measures) Act 2005* (Cth), p 41.

⁹⁸ Board of Taxation, n 97, p 139.

⁹⁹ ITAA 1936, s 139B(1A).

¹⁰⁰ ITAA 1936, s 139(2A).

the exemption and foreign tax credit rules to make it clear that such benefits were employment income¹⁰¹ and some changes to the CGT provisions.¹⁰²

The legislative changes did not identify how to determine the extent to which the taxable amount related to service provided offshore as a foreign resident. The EM indicated that an OECD Report on cross-border income tax issues arising from employee stock option plans provided some guidance on this matter.¹⁰³ The OECD Report released in 2004 included a number of paragraphs in the Commentary to the Model Tax Conventions dealing with employment income and options in particular. It also examined a number of issues including how to apportion taxing rights where the employee has worked in a number of jurisdictions and indicated that a reasonable approach would be to look at the time worked in the relevant foreign service as a proportion of the total period of employment to which the right relates. The legislation was also silent on the particular service period to which the share or rights relates. According to the OECD Commentary, in the case of an option, the relevant service period would typically be from grant to vesting.¹⁰⁴ For an inbound individual who became an Australian employee (and presumably an Australian resident), he or she could either pay tax upfront, that is, when he or she became an Australian employee or defer until a cessation time (generally on exercise of rights or when restrictions no longer apply to shares). In either case, he or she could exclude the foreign service part of the discount. The position was more complex in the case of temporary residents. The complexity arose because temporary residents are not subject to tax on foreign sourced capital gains.¹⁰⁵ The rules were therefore modified to ensure that tax was paid on capital gains on shares or rights acquired under an ESS attributable to the Australian service.¹⁰⁶

Division 83A changed the approach introduced only five years earlier. Instead of having a specific provision excluding the foreign service portion in relation to foreign residents, the EM refers to such an approach being inconsistent with the core rules of the Australian income tax system.¹⁰⁷ Instead the new rules include source rules and then rely on the core rules (ss 6-5 and 6-10) to exclude foreign source income of foreign residents from Australian income tax. The relevant source rules in Div 83A provide:

Treat an amount included in your assessable income as being from a source other than an Australian source to the extent that it relates to your employment outside Australia.¹⁰⁸

The source of particular types of income is generally determined by reference to case law. In the case of payments for services, the source is generally said to be the place where the services are performed. For example, in *FCT v French*,¹⁰⁹ an Australian engineer who was employed by an Australian company but performed services in New Zealand was held to have derived income from New Zealand. Similarly, in *FCT v Efstathakis*,¹¹⁰ a Greek public servant who worked for the Greek Press in Australia was held to have derived her income in Australia because she performed the relevant work here. However, there are other situations where other factors such as the place of contracting¹¹¹ or the place of payment¹¹² may determine source. The matter is even more complex in

¹⁰¹ ITAA 1936, ss 23AF-23AG, 160AEA(1)(g).

¹⁰² ITAA 1936, s 130-80(4).

¹⁰³ Explanatory Memorandum, n 8 at [1.352].

¹⁰⁴ Baillie P and Basker R, "Taxation of Cross-border Employee Shares and Rights: Traps for the Unwary" (2009) 43 *Taxation in Australia* 49.

¹⁰⁵ ITAA 1997, Subdiv 768-R.

¹⁰⁶ ITAA 1997, s 768-920.

¹⁰⁷ Explanatory Memorandum, n 8 at [1.350].

¹⁰⁸ ITAA 1997, ss 83A-25(2), 83A-110(2).

¹⁰⁹ *FCT v French* (1957) 98 CLR 398.

¹¹⁰ *FCT v Efstathakis* (1979) 9 ATR 867; 79 ATC 4256.

¹¹¹ *FCT v Mitchum* (1965) 113 CLR 401 – an actor worked on a film that was filmed in Australia but was subject to some other obligations outside Australia and the contract was entered into outside Australia. The court held that *French* did not necessarily determine the case.

relation to ESSs because in some cases the interests are granted because of past service and in some cases the interests are granted as an incentive to encourage future performance.¹¹³

The approach adopted in Div 83A does not resolve the issue of uncertainty for cross-border employees in relation to source. The approach adopted in Div 83A assumes that it is possible to readily identify the period of employment to which the ESS interests relate and that it will then be possible to apportion based on the period of employment outside Australia. Indeed, the EM suggests that apportionment will be a simple mathematical calculation, but identifying the relevant employment (either past or future) may be more complex. The EM states that apportionment should be done “in a manner consistent with OECD practice as explained in the EM to NITA (FOB and OM) Bill 2005”. According to the OECD, this will often require an individual enquiry to determine whether the amount relates to past services (that is, the ESS interests are given as a reward for past performance) or to future services (that is, that the ESS interests are an incentive for future performance).

There are also various transitional rules and a number of alternatives:

- If the shares or rights were granted before 1 July 2009 and the employee comes to Australia after December 2009 (when the new law became operative), it is not clear that the new law applies. Under Div 13A, the rules only applied because an express provision (s 139B(2A)) stated that the Division became operative when the employee first commenced working in Australia.¹¹⁴
- If the shares or rights are granted on or after 1 July 2009 and have not yet had the ESS deferred taxing point, the new rules would appear to apply on the employee coming to work in Australia. But what if the shares or rights would have been taxable on grant (that is, are not eligible for deferral)? There is no equivalent of s 139B(2A) to make the shares or rights subject to tax on coming to work in Australia and so presumably Div 83A does not apply.

It is also necessary to consider the position of temporary residents in relation to ESOPs. There are no specific references to temporary residents in Div 83A. However, an individual who qualifies as a temporary resident will be exempt from Australian tax on certain foreign-sourced income or capital gains receipts. In essence they are treated similarly to foreign residents even though they would normally qualify as residents under normal tax rules. In general, foreign source income (excluding capital gains) derived by a temporary resident is exempt (s 768-910) but this does not apply to “remuneration from employment undertaken while a temporary resident”. Capital gains (and losses) made by a temporary resident are treated as if made by a foreign resident (s 768-915) and so exempt unless related to real property. Previously there were quite complicated rules relating to ESS interests but the EM states that those rules are no longer necessary. Under these rules, a temporary resident will be subject to tax on ESS interests regardless of the source of the benefits.

THE POSITION UNDER AUSTRALIA’S DOUBLE TAX AGREEMENTS

Australia has entered into 42 DTAs. Such agreements can deal with the double tax issue in two ways. One way is to provide that only one of the parties to the agreement will have taxing rights with respect to the income. Another is to provide for the possibility of both parties taxing the income but require one party to provide credit or other relief to avoid double taxation. The position in relation to employment income under Australia’s DTAs is the latter. As previously mentioned, the OECD has produced a Model Convention that forms the basis for many of Australia’s DTAs subject to modification in particular cases. The relevant Article 15 provides:

Salaries, wages and *other similar remuneration* derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

¹¹² *Evans v FCT* (1981) 12 ATR 313; 81 ATC 4512 – an academic on sabbatical in Switzerland was held to be subject to tax in Australia on the basis that the payment of his salary into an Australian bank account determined the source of payment.

¹¹³ OECD Report, n 89.

¹¹⁴ See *Income Tax (Transitional Provisions) Act 1997* (Cth), s 83A-5(2).

Article 15 notes that income from employment will be taxable in the country of residence but gives the source country the right to impose tax on employment income where the employment is exercised in that country except where the employment is for less than 183 days, payment is made by a foreign resident and there is no deduction in the source country. Article 15 does not give either country an exclusive right to tax income from employment; rather, it accepts that the country of residence has a right to tax the income and also that the country of source has a right to tax the income if the employment is exercised in that country. Australia's DTAs have been fairly consistent in adopting this form of the employment Article. There are some minor variations which are discussed below.

Article 23 then provides that where both the residence and source country have a right to tax, the residence country must provide relief from double taxation by either an exemption or credit. The most common relief is a credit for tax paid; however, credit is also available under Australia's domestic law, that is, regardless of any treaty relief.

Article 15 does not specifically refer to ESSs or indeed any form of non-cash employment benefits. It is, however, accepted that such benefits do fall within the Article. The OECD Commentary in relation to Art 15 notes that member countries have generally understood the term "other similar remuneration" to include benefits received in kind in respect of employment.¹¹⁵

Since 2005 the OECD Commentary has contained specific discussion of employee stock options.¹¹⁶ The Commentary does not specifically deal with shares but many of the issues will be similar – shares may be subject to conditions and so not vest immediately and it may not be clear which period of employment is relevant to the grant. This latter point arises because sometimes the grant of shares or options is to reward past services and sometimes the grant is an incentive relating to future performance.

The Commentary notes that there is no requirement under the Article for a country to tax employment income at a particular time. This means that the possibility that countries will apply tax at different times (perhaps on grant, perhaps on exercise) remains a real risk and increases the likelihood of double taxation. Another factor is whether such benefits should be characterised as employment benefits as opposed to capital gains. In this regard the Commentary adopts an arbitrary rule that treats the benefit up to the time of exercise or disposal of the option as an employment benefit and any subsequent benefit as a capital gain. This does not preclude the benefit being taxed in a particular way for domestic purposes.¹¹⁷ Further, the determination of whether an option is derived from employment exercised in a particular state needs to be done on the basis of all the relevant facts and circumstances including the contractual conditions associated with the option. However, a number of general principles should be followed. First, the option should not be considered to relate to any services rendered after the period of employment that is required as a condition for the employee to acquire the right to exercise the option. In some cases the period referred to will not be a condition but merely a delay during which the right cannot be exercised. In the latter case the benefit should not be considered to relate to the employment during that period. Also, the situation where a benefit vests but may be forfeited differs from the situation where a condition is imposed.

Secondly, an option should only be considered to relate to past services where it is clear that the grant is intended to reward the employee for past performance. This might be demonstrated by the terms of the grant or by consistent past practice by the employer. However, if some factors suggest the option is a reward for past service and some suggest that it relates to future service, it should be recognised that options are generally provided as an incentive to future performance.¹¹⁸ Finally, where the option is derived from employment exercised in more than one country, it will be necessary to determine which part of the benefit is derived from employment in each country. The Commentary

¹¹⁵ OECD Commentary at [2.1].

¹¹⁶ OECD Commentary at [12-12.15].

¹¹⁷ OECD Commentary at [12.2-4].

¹¹⁸ OECD Commentary at [12.5-13].

suggests that this should be done in proportion of the number of days during which employment has been exercised in that country to the total number of days during which the employment services from which the option is derived have been exercised.

None of Australia's DTAs specifically refer to ESSs. However, notes to the United Kingdom Agreement entered into in 2003 make a number of specific comments. They provide that income or gains derived by employees from share option schemes shall be treated as "other similar remuneration". They also provide that the period of employment to which the option relates shall be taken to be the period between grant and vesting of the option (unless the facts indicate otherwise) and the proportion of the gain attributable to employment exercised in a particular country will be determined according to the ratio of the number of days of employment exercised in that country to the total number of days employment between grant and vesting. While this approach has some difficulties (it only deals with options and also indicates that in some cases the approach would not apply), it does have some benefits in spelling out how an apportionment should be done.

Division 83A has adopted the approach of including a "source rule" concerning ESS interests and then referring in the EM to the OECD Commentary as providing a basis for apportionment where an employee works in more than one jurisdiction. This approach presents a number of difficulties. First, the Commentary is limited to options and although the issues may be similar for some shares, this is not spelt out. Secondly, the Commentary itself indicates that it will often be difficult to work out whether it is past or future services that are relevant. Thirdly, if apportionment is appropriate an employee (or their adviser) must have reference to materials (the provisions of the OECD Commentary) that are not readily available.

DOMESTIC RELIEF FROM DOUBLE TAXATION

There are two ways in which an individual can be given relief from double taxation by domestic law. One is an exemption and the other is a credit for taxes paid in another jurisdiction. Under Australian law there is some possibility of exemption but the most common method of relief is by credit. The different forms of relief depend on whether the individual is an Australian resident, a foreign resident or a temporary resident.

For many years Australia has provided an exemption for Australian resident individuals for foreign earnings in certain circumstances.¹¹⁹ In order to qualify for the exemption, the individual needed to complete at least 91 days of continuous foreign service. Where the income was exempt from tax in the foreign jurisdiction, Australian tax may have been payable but only if the foreign exemption arose as a result of defined reasons. The term "foreign service" was defined as service in the nature of employment. The term "foreign earnings" was also defined as income consisting of earnings, salary, wages, commission, bonuses or allowances. In 2005 this was amended to specifically include "amounts included in assessable income under Div 13A". The exemption was available up to the amount of Australian tax payable and adopted a formula (referred to as exemption with progression) which meant that those foreign earnings were taken into account to calculate tax payable on other income. Since 1 July 2009, the exemption is only available for income earned as an aid or charity worker or as a specified government employee (defence and police force deployed overseas).¹²⁰ This appears to have been motivated by revenue concerns and the government has announced that it expects to raise an additional \$675m.¹²¹ The result of this amendment is that many employees will be unable to claim an exemption and will instead need to consider whether they are entitled to an offset. The removal of the exemption may mean that employees are effectively subject to double tax, for example, if the employee is subject to tax in the foreign jurisdiction and the employer company is subject to FBT in Australia.

The other main method for providing relief from double taxation is the credit method. From 1 July 2008, the foreign income tax offset (FITO) rules have applied, which replaced the foreign tax

¹¹⁹ ITAA 1936, s 23AG.

¹²⁰ Inserted by *Taxation Laws Amendment (2009 Budget Measures No 1) Act 2009* (Cth), s 23AG(1AA).

¹²¹ Senate Economics Legislation Committee Report on the *Taxation Laws Amendment (2009 Budget Measures No 1) Bill* (Cth).

credit system that had been in operation since 1987. An entitlement to claim a FITO arises in the year in which an amount on which "foreign tax" has been "paid" is included in assessable income.¹²² A tax offset is not available for a foreign resident where the foreign tax is imposed in the foreigner's jurisdiction of residence under a residence based tax system, that is, where the foreign country (like Australia) taxes its residents on their world-wide income.¹²³ This effectively means that the credit is only available to Australian residents.¹²⁴ One of the difficulties with this system as it relates to ESS interests is that a credit is only available if the foreign tax has been paid. This is likely to give rise to difficulties if the foreign tax is levied (or likely to be levied) at some time in the future. It may, however, be possible to seek an amendment of an assessment¹²⁵ or to claim a credit under the treaty.

The position of foreign residents is determined in part by the core rules, that is, a foreign resident is only subject to tax in Australia on income that has an Australian source¹²⁶ and also Division 83A. As previously noted, under amendments introduced in 2005 the government sought to tax that portion of the ESS benefit which related to service in Australia by excluding that portion which related to foreign service. Division 83A adopts a different approach, setting out a broadly based source rule (ss 83A-25(2) and 83A-110(2)) and then relying on the core rules to exclude any portion that relates to foreign service. It will not always be easy to identify the appropriate employment for the purpose this apportionment. Presumably, foreign residents in countries with which Australia has a DTA will be entitled to a credit for any tax paid in Australia.

The position of temporary residents has also been changed as a result of the introduction of Div 83A. They will be subject to tax in Australia on remuneration from employment undertaken while a temporary resident. In line with the earlier discussion it will be necessary to determine if the ESS interests are derived as a result of employment undertaken while in Australia and this may be difficult. Capital gains (and losses) made by a temporary resident are treated as if made by a foreign resident and so generally exempt.¹²⁷ Under Div 13A, capital gains on ESS interests were generally only exempt if they were subject to tax on acquisition. The amendments mean that the CGT exemption may apply whether the benefits are subject to tax on acquisition or at a later time.

CONCLUSION

Cross-border employees face significant uncertainty with respect to the taxation of benefits that arise under an ESS. Issues associated with the timing of taxation liability, characterisation, whether the benefits are provided with respect to past or future employment give rise to significant prospects of double taxation (or perhaps nil taxation). Despite indications in 2003 that Australia should address the issue through bi-lateral treaty negotiations, only one DTA (with the United Kingdom) negotiated since the issue was raised even addresses the problem and then only in non-binding (presumably) notes.

The NITA Act in 2005 did specifically address the issue and provided a legislative basis for apportionment between countries claiming a right to impose tax. The measures introduced in 2009 appear retrograde since they rely on core rules that do not deal with the complexity of ESS benefits and the EM refers to a methodology that is not readily available.

¹²² ITAA 1997, s 770-10(1).

¹²³ ITAA 1997, s 770-10(3).

¹²⁴ Although the non-resident may be eligible for a tax credit in their home jurisdiction.

¹²⁵ See ATO, *Foreign Tax Credit System – Procedures in Relation to Claims for Foreign Tax Paid*, IT 2527 (4 May 1989).

¹²⁶ ITAA 1997, ss 6-5, 6-10.

¹²⁷ ITAA 1997, s 768-915.