Sellers of Labour or Investors of Intellectual Capital?

Conceptual Problems in the Taxation of Employee Share Ownership in IP Spin-off Companies

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Cameron Rider[1]

ABSTRACT

IP spin-off companies typically face cash-flow constraints which prevent them offering competitive cash-based compensation packages to employees. An important mechanism for counteracting this disadvantage is the use of employee shares in lieu of cash salary– ie the grant of shares which can be acquired by employees at a deep discount to market value (the "acquisition discount"). However, current Australian tax law inhibits widespread use of employee shares by IP spin-off companies, by generally treating the acquisition discount as taxable employment income at the time of grant of the shares, notwithstanding that the discount will be an unrealised and contingent gain, subject to high levels of investment risk.

This paper considers whether this treatment is conceptually appropriate as a matter of tax policy; or whether the acquisition discount should instead be treated as a normal capital gain on a share investment, taxable only when subsequently realised on sale of the share. It is observed that Australian tax policy currently purports to resolve this conceptual problem on the basis of legal form - the acquisition discount is taxed as employment income because it arises as a matter of legal form from an employment contract. This paper argues that the problem should instead be approached from the perspective of economic substance: is the acquisition discount properly treated as the economic equivalent of a cash salary, or should it instead be treated as an unrealised and contingent gain of a share investor?

In considering economic substance, the relationship between risk and reward is relevant. The traditional employee does not take a position of significant investment risk in relation to the company which rewards them for the sale of their labour; they receive a guaranteed, fixed and regular cash salary payable regardless of the economic fortunes of the enterprise. By contrast, the holder of an employee share in an IP spin-off company share investor does take a position of significant investment risk in relation to IP spin-off company; they invest their intellectual capital in the spin-off company, and their reward, including the ultimate realisation of the acquisition discount, depends wholly on the economic fortunes of the enterprise: In other words, their economic risk profile is that of an investor, not a seller of labour.

Hence, a conceptual approach based on economic substance indicates that, as a matter of tax policy, the acquisition discount on employee shares in an IP spin-off company should receive investor tax treatment, and be taxed as a capital gain only when realised on sale of the share. It should not be taxed as employment income.

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Part 1
Introduction and overview

This paper considers some of the conceptual problems which arise in determining how employee shares held in an IP spin-off company should be treated for income tax purposes. It builds on research on the issue by Rider, O'Connell and Hong for IPRIA[2].

1.1 Background

Various studies have identified several general economic benefits associated with employers allowing employees to acquire employee equity[3]. Among these are: that the use of employee equity in lieu of cash compensation is a useful way to attract and retain highly motivated and talented executives and key technical employees; that employee equity aligns the interests of executives and other key employees with that of shareholders; that employee equity can allow employee involvement in company decision-making[4]; and that employee equity, by giving employees an ownership interest in the business enterprise, encourages development of an entrepreneurial culture in the work-place – a factor often identified as critical to successful entrepreneurial activity in industries associated with the development of intellectual property[5].

The specific benefits, and important functions, of employee equity for companies involved in so-called 'sunrise industries'[6] have also been generally acknowledged. Sunrise industry start-up companies, such as IP spin-off companies, commonly face significant cash-flow constraints. They are unable to offer competitive cash-based compensation packages to the executives and other key employees; granting employee equity on generous terms in lieu of cash salary can compensate for this inability to match the cash compensation packages of more established companies. By offering employee equity to employees, the company has not promised to make any current cash payment, but has committed part of its future cash to the employees. The use of employee equity to compensate employees also helps, in some sense, to attract venture capital and other investments. Employee equity, as a form of contingent compensation, places executives' and key employees' interests and risks in line with those of venture capitalists and other investors. It diminishes the incentive for the founders of the start-ups (who are usually executives and key employees) to overestimate the merits of their ideas.[7] Thus it

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2 Forthcoming IPRIA Working Paper, 'Taxation Problems in the Commercialisation of Intellectual Property' by Rider, Hong, Stewart, O'Connell, Herring; see especially Chapter 9 (Does the Income Tax System Discourage Employee Share Ownership in IP Spin-off Companies) and Appendix C (Taxation of Employee Stock Options in Start-up IP Firms: A Comparison of US Treatment and Australian Treatment).

3 See Jarrod Lenne, Richard Mitchell and Ian Ramsay, 'Employee Share Ownership in Australia: A survey of key issues and themes', Centre for Corporate Law and Securities Regulation and Centre for Employment and Labour Relations Law, The University of Melbourne (2005).

4 Richard Mitchell, Anthony O'Donnell and Ian Ramsay, 'Shareholder Value and Employee Interests: Intersections Between Corporate Governance, Corporate Law and Labour Law', Centre for Corporate Law and Securities Regulation and Centre for Employment and Labour Relations Law, The University of Melbourne (2005).

5 See OECD Directorate for Science, Technology and Industry, *Entrepreneurship and Growth: Tax Issues* (February 2002); William M Gentry and R Glenn Hubbard, '"Success Taxes", Entrepreneurial Entry and Innovation' (June 2004) National Bureau of Economic Research Working Paper 10551; Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey S Rosen, "Entrepreneurs, Income Taxes and Investment" (1998) NBER Working Paper 6374.

6 The terms 'sunrise industry' and 'sunrise enterprise' are used in *Shared Endeavours*, a report by House of Representatives Standing Committee on Employment, Education and Workplace Relations. A 'sunrise industry' is knowledge intensive, in an emerging area of the economy and commercialising recently developed technology and/or research and development outcomes. A 'sunrise enterprise" is a small or medium size company that is less than 5 years old and operates in a sunrise industry and/or is relying on venture capital.

7 Joseph Bankman, 'The Structure of Silicon Valley Start-ups', (1994) 41 UCLA Law Review 1737, at page 1750.

increases the credibility of the success of their ideas and reduces the information costs to the investors[8].

It is generally acknowledged that the existing taxation arrangements for employee shares are sub-optimal in relation to sunrise industry enterprises, such as IP spin-off companies[9]. The Nelson Report into share ownership singled out this area as one requiring reform, but to date the government has not acted on the recommendations in the report[10]. Among the problems identified for sunrise enterprises are: that employees in receipt of shares in lieu of salary will generally be taxed at ordinary income tax rates in respect of the market value of the shares at issue date, notwithstanding that any gain on the shares will be unrealised at that point and will be highly contingent due to the high-risk nature of investment in such enterprises; that the employee will need to find cash to meet the cash tax liability, which defeats the object of seeking to use employee shares to compensate the employee for the company's inability to pay a competitive cash salary; and that existing tax concessions in the tax law designed to mitigate some of these consequences cannot be accessed by sunrise enterprises because the concessions are subject to conditions designed to be met by established (and usually listed) companies.

1.2 The nature of the conceptual problem for employee shares in IP spin-off companies

This paper is, however, primarily concerned with a conceptual problem which has been identified in relation to the taxation treatment of employee shares. This problem concerns the question of whether the gains derived by the employee in relation to the employee shares should be treated as in the nature of capital gains – which is the normal treatment of gains on share investments – or whether the gains should be treated as in the nature of employment income – which is the normal treatment of benefits received in respect of employment.

The distinction is of importance because, under current taxation law, the marginal rate of taxation of capital gains of individuals, on assets held for at least 12 months, is one half of the marginal rate of tax on ordinary employment income. This difference arises because of the 'CGT discount' concession for individuals, which allows individuals to pay tax at their marginal rate on only 50 per cent of any capital gain realised on shares held for at least 12 months. Another important aspect of capital gains tax treatment is that capital gains are only taxable, in general, if and when they are realised on an actual disposal of the shares.

The policy rationale for the CGT discount is that it is a reward for the increased levels of risk faced by investors in CGT assets. Current theory supports the difference primarily on the grounds that it is necessary to encourage savings and investment, particularly long-term and risky investment[11]. The preferential tax treatment offsets the business risk associated with such investment, and so encourages higher levels of investment than would otherwise be the case. The case for preferential treatment is often said to be stronger in the case of high-risk investment in venture capital and high-technology start-up industries[12].

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8 *Ibid.*

9 See n.1.

10 House of Representatives Standing Committee on Employment, Education and Workplace Relations Report, 'Shared Endeavours – An inquiry into employee share ownership in Australia' September 2000. Recs 32-39.

11 See Review of Business Taxation, *A Platform for Consultation*, AGPS (1999), especially Chapter 11 'Towards a more Competitive Regime for Taxing Capital Gains'.

12 Review of Business Taxation, *A Platform for Consultation*, AGPS (1999), pages 286 -289.

The difference in treatment is of greatest importance for employee shares in relation to the *'acquisition discount'* – that is, the difference between the market value of the share at the date of issue and the nominal amount of money (if any) the employee pays to the company as the issue price for the share. So, for example, if the company issued the employee a share with a market value of $1.01, and the employee paid one cent as the issue price for the share, the acquisition discount would be $1.00. The critical question is whether this $1.00 acquisition discount should be accorded employment income treatment or capital gains treatment.

Australian taxation law currently adopts the conceptual position that gains on employee shares should be treated as in the nature of employment income – that is, the shares should be given the same treatment as other benefits received in respect of employment. The consequence of this conceptual approach is that the employee will generally be subject to tax immediately on the acquisition discount on employee shares in an IP spin-off company, and will pay tax at ordinary marginal rates on the acquisition discount. So, to continue the example, the $1.00 acquisition discount would be treated as in the nature of employment income, and the employee would pay tax on that $1.00 at their ordinary marginal income tax rate.

By contrast, if capital gains tax treatment were afforded the employee shares in the IP spin-off company, the position would be different. The employee would be treated as an investor in the company, and would not pay tax on any acquisition discount, as this would be treated as an unrealised (and contingent) capital gain. Further, so long as the share was held for at least 12 months, any subsequent realisation of the acquisition discount on sale would attract the benefit of the CGT discount, meaning that only half the acquisition discount would be taxed. So, to continue the example, if capital gains tax treatment were afforded, only 50 cents of the $1.00 acquisition discount would be taxed at the employee's marginal tax rate and, further, it would only be taxed if it was actually realised on ultimate sale of the shares.

1.3 Suggested resolution of problem – the role of investment risk in determining if CGT treatment should apply

Many advocates for employee share ownership have argued that capital gains tax treatment should be afforded the acquisition discount on employee shares. It is argued that this is necessary to encourage greater employee share ownership, and ensure that employee shares are not a disadvantaged form of investment relative to other forms of investment which can attract the CGT discount treatment[13]. Others have taken the view that employment income treatment should apply to the acquisition discount because it is a gain derived directly from the employment relationship, and that accordingly the capital gains tax treatment should only extend to any subsequent appreciation in value of the shares after the issue date[14]. The latter view was ultimately the position adopted by the Nelson Report: it recommended that, when the share was disposed of, the gain should be dissected into an employment income component and a capital gains component – the employment income component being the acquisition discount, indexed by application of a compound interest rate, and the capital gain component being the balance of the gain[15].

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13 See the discussion of submissions to this effect in House of Representatives Standing Committee on Employment, Education and Workplace Relations Report, 'Shared Endeavours – An inquiry into employee share ownership in Australia' September 2000, paragraphs 4.37 to 4.67. The inquiry did not accept these submissions.

14 See Australian Chamber of Commerce and Industry, *Taxation Reform Blueprint: A Strategy for the Australian Taxation System 2004-2014* (Nov 2004), Chapter 8 (Employee Share Ownership Plans and Taxation) and Employee Ownership Group, "Employee share ownership in Australia: the future" at http://www.eogroup.org/.

15 n.10, paragraph 4.67 (Recommendation 27).

While acknowledging the force of these arguments from the perspective of legal form, this paper will argue that there is an alternative way to resolve the conceptual problem as to the appropriate way in which to treat employee shares for taxation purposes. This alternative approach involves considering whether, as a matter of economic substance, the acquisition discount can reasonably be regarded as the equivalent of money wages or salary. In considering this, the concept of investment risk is identified as the critical determining factor.

The traditional employee does not take a position of significant investment risk in relation to the company which rewards them for the sale of their labour (or labour time); instead they receive a guaranteed, fixed and regular cash wage of salary which is legally due and payable regardless of the economic fortunes of the enterprise. By contrast, the share investor does take a position of significant investment risk in relation to the company in which they acquire shares; the return on their shares – *including, in particular, the ultimate realisation of any acquisition discount* - is neither guaranteed, nor fixed nor regular, but rather depends wholly on the economic fortunes of the enterprise. Indeed, this fact has been indirectly recognised in some critiques of employee share plans, which argue that employees should not be compelled to exchange risk free cash wages and salaries for employee shares which expose them to increased levels of financial risk[16].

Further, in considering the appropriate characterisation of the acquisition discount on shares in an IP spin-off company, it needs to be kept in mind that preferential capital gains tax treatment is intended to apply where investments are made at risk in a company, and is intended to be compensation for that investment risk. As noted above, the CGT discount is intended, among other things, to offset the business risk associated with high-risk investment in venture capital and high-technology start-up industries[17]. Thus, capital gains tax treatment will be appropriate where the employee share arrangement involves the employee taking a position of substantial investment risk in relation to the company, as compared to the position of no investment risk which applies where the employee is rewarded by weekly or monthly wage and salary payments.

It is submitted that, for employee shares in an IP spin-off company, a position of substantial investment risk is taken in relation to *the ultimate realisation* of any acquisition discount, and that accordingly capital gains tax treatment should be afforded the acquisition discount. In other words, the discount should not be taxed unless and until it is actually realised on disposal of the employee shares, and at that time it should attract the CGT discount. It is, with respect, conceptually flawed to treat the acquisition discount on shares in an IP spin-off company as an employee benefit realised on acquisition of the shares, since the acquisition discount is an unrealised and contingent gain whose ultimate realisation is subject to high levels of post-acquisition investment risk.

As the above argument will indicate, this paper accordingly considers the concept of investment 'risk' as being critical to evaluating the appropriate taxation treatment of employee equity. It is, perhaps, useful to outline what is meant when the term risk is being used in this paper. 'Risk' in its simplest sense means the variability of returns on investments[18]. Risk can take many forms – currency risk, exchange risk, exposure risk (the risk associated with investments in a particular industry sector, country, company, etc), market risk (risk that relates to the market as a whole), operations risk,

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16 See Jarrod Lenne, Richard Mitchell and Ian Ramsay, 'Employee Share Ownership in Australia: A survey of key issues and themes', Centre for Corporate Law and Securities Regulation and Centre for Employment and Labour Relations Law, The University of Melbourne (2005), at page 13; and also Recommendation 25 of the Nelson Report (House of Representatives Standing Committee on Employment, Education and Workplace Relations Report, 'Shared Endeavours – An inquiry into employee share ownership in Australia' September 2000).

17 Review of Business Taxation, *A Platform for Consultation*, AGPS (1999), pages 286 -289.

18 See *The Australian Financial Review Dictionary of Investment Terms from Country Investment Management* (John Fairfax Publications, 5th ed 2000). The following discussion is extracted from the definitions of risk in this book.

political risk and volatility. 'Volatility' includes the extent of fluctuation in share prices. The higher the volatility the less certain the investor is of return.

The risk of an asset, as defined by its price volatility, is usually divided into 'systematic risk' and 'specific risk'. 'Systematic risk' is the portion of the risk that relates to movements in the underlying market of which this asset forms part. 'Specific risk' is the uncertainty in the return of a share arising from factors that are specific to the company concerned. Investment in an IP spin-off company will inevitably attract a high level of both *systematic risk* – as evidenced by the fluctuating fortunes of technology stocks on world stock exchanges in recent years – and *specific risk* – given the high-risk associated with any individual IP commercialisation project. This provides, it is submitted, the conceptual basis for affording capital gains tax treatment to the acquisition discount on shares in IP spin-off companies.

1.4 Structure of paper

This introduction and overview outlines the general argument of this paper.

Part 2 deals with the traditional distinction drawn by taxation law between employment income and capital gains. It explains how capital gains on investments are afforded preferential treatment relative to ordinary employment income, and that this is said to be justified on policy grounds because capital investments, such as share investments in high-risk technology companies, are considered to be subject to high levels of business risk. The preferential treatment is designed to partly offset the risk and so encourage a greater level of such investment than would otherwise be the case.

Part 3 explains the conceptual problem in characterising employee shares in an IP spin-off company for taxation purposes: on the one hand, the fact they are received in the context of an employment relationship suggests they should be treated as employment income; on the other hand, the high levels of investment risk attached to the shares suggests they should be treated as normal share investments eligible for preferential capital gains treatment.

Parts 4 and 5 compare the generally harsh taxation treatment of employee shares with the generally more favourable treatment afforded other share investments under current law. The differences arise from the fact that current income tax law treats the employee shares as employment income rather than normal share investments.

Parts 6 and 7 consider various forms of tax relief which are available either under the tax statute, or by virtue of tax planning, for employee shares, but conclude that the relief has very limited practical application in the case of an IP spin-off company.

Part 8 argues that a conceptual resolution of the taxation problem requires us to analyse whether the shares in the IP spin-off company can reasonably be characterised as the equivalent of cash wage or salary income, if proper weight is given to the relationship between risk and reward which the recipient of the employee shares faces in these circumstances. It is suggested that the recipient of cash wages or salary has a position of no investment risk in relation to their employer company, because their return is a guaranteed, fixed and regular payment, legally payable regardless of the fortunes of the enterprise. By contrast, the recipient of employee shares in an IP spin-off company takes a position of substantial investment risk, because their return is neither guaranteed, nor fixed, nor regular. As such, employee shares in an IP spin-off company should be treated for taxation purposes as making a normal share investment, and not as if they were in receipt of the equivalent of a cash wage or salary. From this it follows that they should not be treated as employment income, but rather afforded CGT treatment.

Part 9 draws some brief conclusions.

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Part 2
The distinction between employment income and capital gains

For taxation purposes 'personal income' may be defined conceptually as the net increase in a person's wealth between two points in time, plus the wealth consumed in that interval[19]. In practice, tax laws in most countries tend to make important distinctions between increases in wealth attributable to 'ordinary income', such as employment income in the form of wage and salaries, and increases in wealth attributable to 'capital gains', such as gains realised on the appreciation in value of investments.

In Australia, capital gains of individuals have historically received preferential treatment relative to ordinary income. Ordinary income, such as wages and salary, has always been subject to full taxation at the prevailing marginal tax rates. Prior to 19 September 1985, capital gains on investments were generally tax exempt. From that date to 21 September 1999 capital gains were only taxed to the extent the gain on the investment exceeded the inflation rate as measured by the consumer price index. Since 21 September 1999, under the so-called 'CGT discount' rules, only half the nominal capital gain on an investment of an individual has been subject to taxation, provided the investment is held for at least one year. Further, capital gains on the appreciation in value of investments are only taxed on a realisation basis; ie if the investment is actually disposed of at a price capturing the appreciation in value.

The conceptual basis for allowing preferential treatment to capital gains relative to ordinary income is not without controversy[20]. Current theory supports the difference primarily on the grounds that it is necessary to encourage savings and investment, particularly long-term and risky investment[21]. The preferential tax treatment offsets the business risk associated with such investment, and so encourages higher levels of investment than would otherwise be the case. The case for preferential treatment is often said to be stronger in the case of high-risk investment in venture capital and high-technology start-up industries[22]. It is also noted that such industries need to compete for investment capital in international markets, so that capital gains tax treatment in Australia needs to be no less favourable than capital gains tax treatment in other countries[23].

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19 This is the 'Haig-Simons' comprehensive definition of personal income: see Simons, *Personal Income Taxation. The Definition of Income as a Problem of Fiscal Policy*, University of Chicago Press (1938), Chapter II, page 50: 'Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning'.

20 For a detailed critique see Holmes, *The Concept of Income. A Multi-disciplinary Analysis*, IBFD Publications BV (2000).

21 See Review of Business Taxation, *A Platform for Consultation*, AGPS (1999), especially Chapter 11 'Towards a more Competitive Regime for Taxing Capital Gains'.

22 Review of Business Taxation, *A Platform for Consultation*, AGPS (1999), pages 286 -289.

23 Review of Business Taxation, *A Platform for Consultation*, AGPS (1999), page 288.

Part 3
Employee shares and IP spin-off companies: the conceptual problem

A limited liability corporation formed to commercialise intellectual property is commonly referred to as an 'IP spin-off company'. The term is descriptive of commercialisation activity which has its origins in research and development activity conducted by individuals, companies or institutions. Knowledge, ideas and inventions which are generated by the research and development, and identified as having the potential to be converted into sources of commercial revenue, are transferred into a special purpose 'spin-off company' for the purpose of developing the intellectual property to the point where it can be used in the production of marketable goods and services.

In its early phases of operation a spin-off company will typically face significant cash-flow constraints. It is a common-place method of operation for the individuals associated with the commercialisation activity of the spin-off to agree to provide their labour (at least in the early phases) in exchange for shares in the spin-off company, rather than for a normal cash salary or wage.

3.1 Sellers of labour or investors of intellectual capital?

These arrangements are commonly referred to as 'employee share arrangements', since the individuals will usually (although not always) be regarded as employees of the company from the perspective of their formal legal position. This formal label does, however, obscure the true economic nature of the relationship. In substance, the individuals are partners in the economic enterprise constituted by the spin-off company. They agree, like partners, to contribute their labour to the enterprise in exchange for an equity share in the profits of the enterprise. The value of the labour contributed is the equivalent of an 'at risk' investment in the enterprise.

Thus such 'employees' can be seen, from an economic perspective, as investors of intellectual capital, rather than sellers of labour, in relation to the spin-off company. The economic relationship is far removed from the traditional salaried employee who makes no 'at risk' investment, but instead receives a guaranteed, fixed and regular cash salary for the sale of their labour which is legally due and payable regardless of the economic fortunes of the enterprise.

3.2 Problems in taxation law characterisation

It is difficult to think of any policy rationale for the income tax law to operate so as to discourage employee share arrangements in IP spin-off companies. The spin-off company will typically lack the cash-flow to provide a normal cash salary or wage, so the arrangement cannot be characterised as having tax avoidance aspects. On the contrary, given the cash-flow constraints, the arrangement is commercially efficient, and in many cases commercially essential. It also has the added advantage of giving the individuals an equity interest in the outcome of the activity, and hence an increased incentive to remain with the company until it reaches the stage of a successful commercialisation.

The tax law finds it difficult, however, to determine the proper conceptual approach to the problem of taxing employee shares in IP spin-off companies. On the one hand the shares represent a reward for the sale of the employee's labour (or labour time) to the IP spin-off company, the shares being a substitute for foregone wages or salary. This suggests that the shares should be treated as ordinary employment income equivalent to the wages and salaries foregone. On the other hand, the shares also represent an 'at risk' investment in the IP spin-off company. This suggests they should they be treated

as investments eligible for the preferential capital gains treatment, including the CGT discount, otherwise accorded by the tax law to share investments by individuals.

The appropriate resolution of the conundrum may ultimately be a question of judgment based on policy objectives. However, this is a case where competing policy considerations are at work. On the one hand, treating the shares as ordinary employment income preserves equity between employees who derive wages and salary and those able to access employee share arrangements; it also limits the extent to which employee shares may be used as a device to avoid tax on employment income by converting remuneration in the form of wages and salary to remuneration in the form of preferentially taxed capital gains[24]. On the other hand, treating the employee shares as investments eligible for capital gains treatment, including the CGT discount, is consistent with the general policy of using preferential capital gains treatment to encourage 'riskier' investment in high-technology start-up industries; it may also encourage employees to develop a more 'entrepreneurial' approach to investment of their labour[25].

The position under current Australian tax law is now considered.

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[24] For a discussion of these issues see *Shared Endeavours, Inquiry into employee share ownership in Australian enterprises*, AGPS (2000), a report by House of Representatives Standing Committee on Employment, Education and Workplace Relations, especially at paragraphs 3.8 to 3.28 and 4.37 to 4.67.

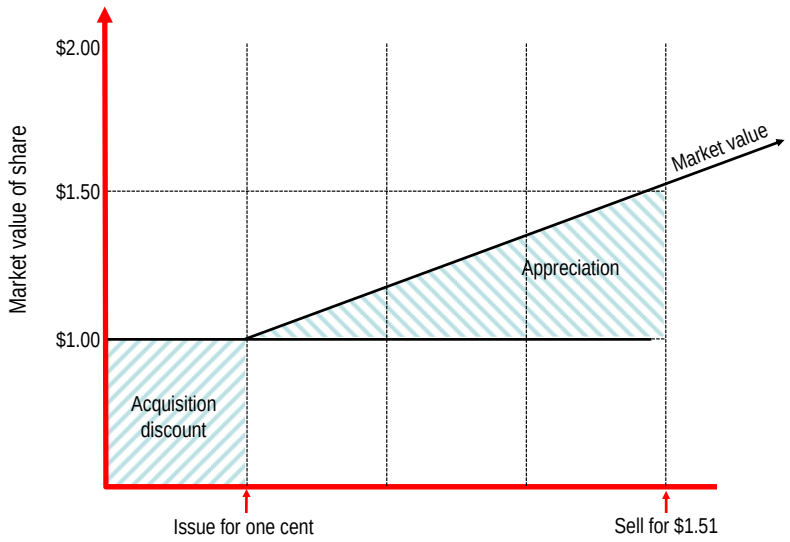
[25] See OECD Directorate of Science, Technology and Industry, *Entrepreneurship and Growth: Tax Issues*, OECD (2000), especially at pages 20 to 25.

Part 4
Basic tax position of employee on employee shares[26]

Division 13A of *Income Tax Assessment Act 1936* and Subdivision 130-D of the *Income Tax Assessment Act 1997* apply to shares acquired by employees in respect of employment[27]. They operate where a share is acquired at a 'discount' to market value (the 'acquisition discount') – ie where the employee acquires the share for nil payment, or for a payment less than the market value of the share[28], and then, at a later date, sells the share.

The taxation treatment needs to address both the acquisition discount, and any subsequent appreciation in the market value of the share (see figure 1).

Figure 1: Shares issued at discount



4.1 Basic taxation position of employee

The basic position on an employee share acquired at a discount is as follows:

(a) The *prima facie* rule is that the 'acquisition discount' is treated as employment income of the employee derived on acquisition of the share, and taxed at ordinary income tax rates[29]. So, for example, if the company issued the employee a share with a market value of $1.01, and the employee paid one cent as the issue price for the share, the employee would include the $1.00 acquisition discount in their taxable income. As this is treated as in the nature of employment income, the employee would pay tax on that $1.00 at their ordinary marginal income tax rate.

(b) The employee is then treated, for capital gains tax purposes, as having acquired the share itself at that point for a cost equal to its market value at acquisition date[30]. So, to continue the

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26 Similar rules apply to employee share options.
27 The rules also apply to shares acquired by contractors in exchange for shares: section 139C(2) of 1936 Act.
28 They don't apply if the share is acquired for a payment equal to or greater than market value.
29 Section 139B(2) and 139CC(2) of 1936 Act. See also *Abbott* v *Philbin (Inspector of Taxes)* [1961] AC 352.
30 Section 130-80 of the 1997 Act.

example, the employee would be treated for capital gains tax purposes as acquiring the share for $1.01.

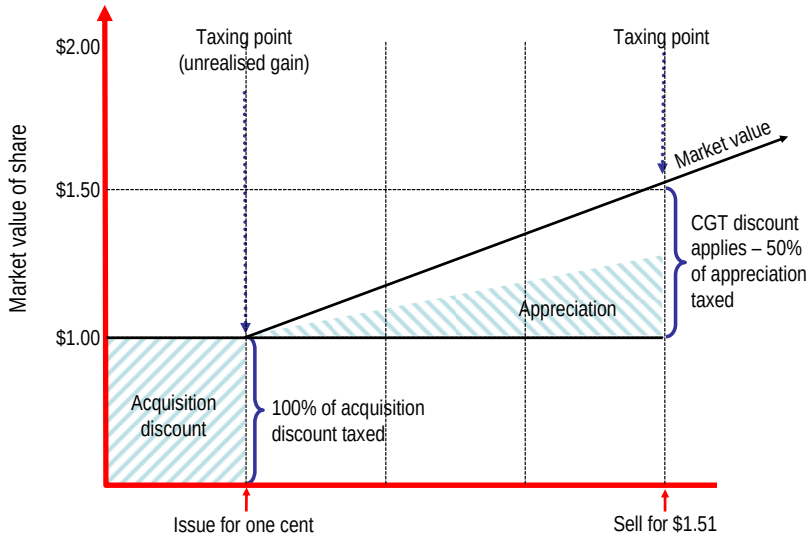
(c) From this point 'capital gains treatment' applies to subsequent dealings with the share, i.e.:

(i) If the share merely retains its value after that date and then is sold by the employee, no further tax is payable.

(ii) If the share subsequently appreciates in value after the acquisition date and is sold by the employee, the appreciation in value will be taxed as a capital gain. If the share is held at least 12 months, only half the gain will be taxable under the CGT discount rules[31]. So, to continue the example, if the share appreciated in value from $1.01 to $1.51, and was sold after more than 12 months, only half the gain ($0.25) would be subject to tax – meaning the effective tax rate is half the employee's ordinary marginal tax rate.

(iii) If the share subsequently declines in value after the acquisition date and is sold by the employee, the decline in value will be recognised as a capital loss. A capital loss cannot be used as a tax deduction against ordinary income such as wage or salary income of the employee: it can only be deducted against other capital gains of the employee[32]. So, to continue the example, if the share depreciated in value from $1.01 to $0.51, and was sold, the employee would have a capital loss of $0.50 which could only be used against other capital gains.

Figure 2: Taxation of employee share – general position



31 Under the discounted capital gains rules in Division 115 of the 1997 Act.
32 Division 102 of 1997 Act.

4.2 Conceptual model underlying basic tax position of employee

Hence the conceptual model is that the employee is treated as if they have received a money wage equal to the acquisition discount in the capacity of an employee, and then re-invested it in shares in the company in the capacity of an investor. This model has five consequences of note:

One: The acquisition discount is treated as a gain realised on acquisition of the share, even though it is at that time still contingent in terms of 'cash realisation' – the discount will not be converted to cash unless and until the share is sold at a price at least equal to the market value at acquisition date.

Two: The acquisition discount is treated as ordinary employment income like wages and salary, rather than as a capital gain.

Three: It is necessary to obtain a market valuation of the share at acquisition date.

Four: The employee has a cash tax liability at acquisition date, equal to their marginal tax rate multiplied by the acquisition discount, which they need to pay from other cash resources. This defeats the object of an IP spin-off company in using employee shares to conserve cash.

Five: While the acquisition discount is taxed as ordinary income like wages and salary, if the share declines in value, the corresponding loss is treated as a capital loss which is 'quarantined' for taxation purposes – that is, it cannot be deducted against wages and salary, but only against other capital gains.

4.3 Taxation disincentives in basic tax position

The basic taxation treatment thus provides no incentive to the employee to forgo wages or salary in an IP spin-off company in exchange for shares. They are in no better position than if they had been paid a cash wage or salary equivalent to the acquisition discount on the shares, and reinvested it in shares. Further, to fund their investment they will need to borrow to pay the tax liability.

Indeed, the treatment also contains a significant disincentive to taking the shares. This arises from the fact that the employee faces the risk of being left with a 'quarantined' capital loss if the shares should ultimately decline in value, notwithstanding that the initial acquisition discount was taxed as ordinary income. Given the high levels of risk associated with the operations of an IP spin-off company, there is a corresponding high risk that the unrealised (but taxed) acquisition discount will ultimately remain unrealised, with the employee then left with a quarantined capital loss of no immediate value.

The taxation of the 'acquisition discount' can also be seen to result in potential double taxation. The 'acquisition discount' is the difference between the price, if any, paid for the shares and their market value at acquisition. The market value of the shares at this time will merely represent the present value of the IP's potential to generate future income. If and when that future income is actually generated, it will be taxable at that time in the hands of the spin-off company and, if distributed as dividends on the shares, taxable again in the hands of the employees as shareholders. The tax law is thus seen to produce taxation of unrealised potential income, and, if that potential is realised, double economic taxation.

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Part 5
Basic position of share market investor compared

The tax treatment of the employee can be contrasted with that which applies to a share market investor who acquires shares in a company at a discount to market value.

5.1 Basic taxation position of investor

For a normal investor, the taxation treatment is more favourable than for an employee, in relation to shares issued with an acquisition discount:

(a) The *prima facie* rule is that the 'acquisition discount' is *not* treated as income of the share market investor on acquisition of the share, and is *not* otherwise taxable at that point. So, for example, if the company issued the investor a share with a market value of $1.01, and the investor paid one cent as the issue price for the share, the investor would not include the $1.00 acquisition discount in their taxable income.

(b) The share market investor is treated, for capital gains tax purposes, as having acquired the share at a cost equal to the initial discounted purchase price they actually paid for the share at acquisition date. To continue the example, the investor would simply be treated as having acquired a share for a price of one cent.

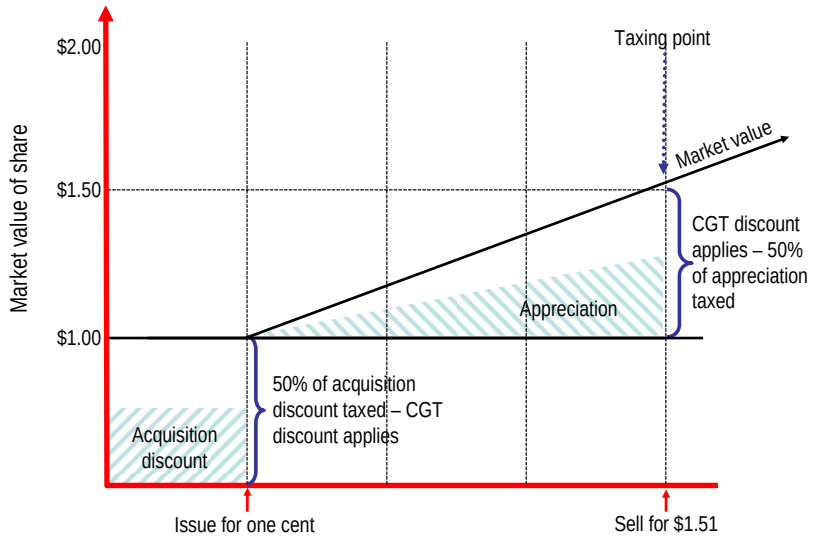
(c) 'Capital gains treatment' applies to any gains or losses on the share:

  (i) If the share merely retains its market value and is subsequently sold, the investor is taxed on the difference between the one cent issue price and the sale price. The difference is treated as a capital gain. For individuals, if the share is held at least 12 months, only half the difference will be taxable, under the CGT discount rules. So, to continue the example, if the share is held for 12 months and then sold for $1.01, the investor pays tax on half the $1.00 difference (i.e. 50 cents). This contrasts with the employee who, as noted above, pays tax on 100% of the difference (i.e. $1.00).

  (ii) Likewise, if the share appreciates in value - and is subsequently sold, for the investor, the total difference between the initial discounted purchase price (one cent) and the final sale price will be taxed as a capital gain, again subject to the CGT discount rules. So, to continue the example, if the share appreciates in value to $1.51, the investor will be subject to tax on only half the difference between issue price and sale price (i.e. on a gain of 75 cents). This contrasts the employee who, as noted above, pays tax on 100% of the difference (i.e. $1.50)

  (iii) If the share subsequently declines in value below the initial purchase price and is sold by the share market investor, the decline in value will be recognised as a 'quarantined' capital loss which can only be deducted against other capital gains. In this case, the capital loss would be one cent, reflecting the actual economic loss of the investor since they only paid one cent.

Figure 3: Taxation of investor – general position



5.2 Conceptual model underlying basic tax position of investor

Hence the conceptual model is that the any gain realised by the share market investor on the difference between what they pay for the share and the final sale price should be treated as a capital gain. This model has five consequences of note:

One: The acquisition discount is *not* treated as a gain realised on acquisition of the share – it is not recognised for taxation purposes unless and until it is converted to cash by sale of the share at a price at least equal to the market value at acquisition date.

Two: The acquisition discount is treated as a capital gain, eligible for the CGT discount, *not* ordinary income.

Three: It is *not* necessary to obtain a market valuation of the share at acquisition date.

Four: The investor will *not* have a cash tax liability at acquisition date which they need to pay from other cash resources.

Five: It is consistent with the treatment of any acquisition discount as a capital gain, that any corresponding loss is treated as a 'quarantined' capital loss which cannot be deducted against wages and salary, but only other capital gains.

5.3 Position of investor more favourable than employee

It will be seen that the conceptual model applied to the share market investor results in a tax treatment more favourable than that which arises under the conceptual model applied to the employee. In particular:

(a) The share market investor obtains capital gains treatment on the acquisition discount, while the employee is taxed as if the acquisition discount is ordinary employment income analogous to wages or salary.

(b) The share market investor is not taxed on the acquisition discount unless and until the share investment is realised, while the employee is taxed on the unrealised acquisition discount at the time the share is acquired, even if the discount is never subsequently realised.

The unfavourable position of the employee share recipient relative to the investor has been the subject of some attention in the existing tax law, and the need to provide some form of relief has been recognised. We now turn to consider this.

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Part 6
Concessions under Division 13A for employee share plans

Division 13A offers employees[33] certain tax 'concessions' which are designed to encourage acquisition of shares in an employer company by providing a limited measure of relief from the basic tax position described above.

6.1 Deferral concession for employee shares

One source of limited relief is a 'deferral concession'. This is designed to deal with the problem that the acquisition discount is *prima facie* taxed as a realised gain on acquisition date, giving the employee a cash tax liability which they need to pay from other cash resources.

To attract the deferral concession, it is first necessary, but not sufficient, that the share be a 'qualifying share'. This requires that it be issued in the following circumstances[34]:

(a) It must be a share acquired under an employee share scheme.

(b) It must be a share in the employer or a holding company of the employer.

(c) It must be an ordinary share.

(d) Shares under an employee share scheme must have also been offered to at least 75% of the permanent employees of the employer (being full-time or permanent part-time with 36 months service).

(e) The employee must not end up owning more than 5% of company shares.

(f) The employee must not end up controlling 5% of votes at a general meeting.

It will be seen that satisfaction of these conditions will often be problematic for a start-up IP spin-off company with a small number of employees. In particular, problems will arise in meeting the requirements to offer shares to 75% of permanent employees, and to limit individual holdings to less than 5%.

In addition, for the deferral concession to have any value, the 'qualifying share' must be acquired on terms which *defer* the point at which the employee can enjoy unfettered ownership of the share. That is, the share must be acquired subject to restrictions which prevent the employee disposing of it for a period, or which make the employee liable to forfeit ownership on certain conditions. In such a case:

(a) The employee, unless they elect otherwise, is not taxed on the acquisition discount at the time of acquiring the shares[35].

(b) Instead, the employee is not taxable until the earliest of the following 'cessation times'[36]:

    (i) when the restrictions on disposal or the forfeiture conditions cease;

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33 But not contractors.
34 Section 139CD of 1936 Act.
35 Section 139B(3) of 1936 Act.
36 Section 139CA(2).

(ii) when the share is actually disposed of;

(iii) when the employment ceases;

(iv) on expiry of 10 years from acquisition date.

(c) However, at this 'cessation time', the employee is not taxed on the 'acquisition discount' but rather they are taxed on the 'cessation time discount' – i.e. the difference between any amount paid for the share and its market value at the cessation time[37]. So, for example, if the company issued the employee a share with a market value of $1.01, and the employee paid one cent as the issue price for the share and elected the deferral concession, and then *at the cessation time* the market value of the shares had increased to $1.51, the employee would include $1.50 in their taxable income. This would again be treated as in the nature of employment income, so they would pay tax on that $1.50 at their ordinary marginal income tax rate. The CGT concession would not apply. The employee is worse off for having elected the deferral concession, because it has meant that 100% of the $0.50 appreciation in the value of the share between the acquisition date and the cessation time has been taxed as ordinary employment income rather than as a discounted capital gain. If they had not elected the deferral concession, they would have paid tax on the initial acquisition discount (of $1.00), but only half the subsequent appreciation in value ($0.50), meaning the total taxable gain would be $1.25 and not $1.50.

(d) From the taxable cessation time, the employee is then treated, for capital gains tax purposes, as having acquired the share itself for a cost equal to its market value at the cessation time[38].

(e) From this point 'capital gains treatment' applies to subsequent dealings with the share, i.e.:

(i) If the share merely retains its value after that date and then is sold by the employee, no further tax is payable.

(ii) If the share subsequently appreciates in value after the acquisition date and is sold by the employee, the appreciation in value will be taxed as a capital gain. If the share is held at least 12 months, only half the gain will be taxable under the CGT discount rules[39].

(iii) If the share subsequently declines in value after the acquisition date and is sold by the employee, the decline in value will be recognised as a capital loss, which can only be deducted against other capital gains of the employee.

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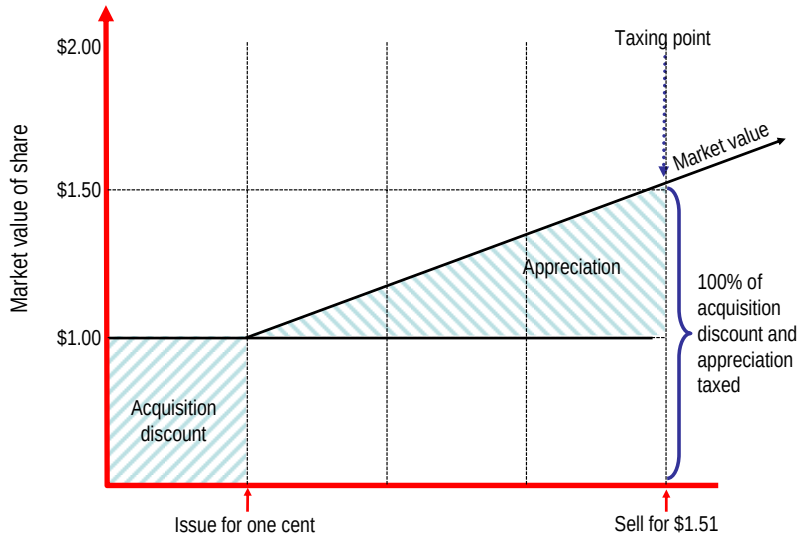
37 Section 139CC(3) and (4) of the 1936 Act. If the shares are actually sold within 30 days of the cessation time, the sale price is used as the proxy for market value.

38 Section 130-83 of the 1997 Act. If the shares are actually sold within 30 days of the cessation time, there is no capital gains liability.

39 Under the discounted capital gains rules in Division 115 of the 1997 Act.

Figure 4: Taxation of employee share – deferral concession under Division 13A



Hence the conceptual model for the deferred concession is that the employee is treated as if they have received a money wage equal to the cessation time discount in the capacity of an employee, and then re-invested it in shares in the company in the capacity of an investor. This model has two consequences of note:

(a) The cessation time discount is still treated as ordinary employment income like wages and salary, rather than as a capital gain. Hence the full amount of any appreciation in value in the share from the time of acquisition is treated as ordinary employment income, rather than a capital gain eligible for preferential capital gains treatment.

(b) The requirement of the deferral concession that there must be a deferral of the time at which the employee can obtain an unfettered ownership right, means that the holder of an employee share must subject themselves to commercial and legal constraints which place them at a disadvantage relative to a normal investors in shares.

Thus the deferral concession only provides a limited incentive to the employee to forgo wages or salary in an IP spin-off company in exchange for shares. They are, in terms of taxation treatment, in no better position than if they had agreed to accept payment of a deferred cash wage or salary equivalent to the cessation discount on the shares, and then reinvested it in shares at the cessation time. Arguably, they are in a worse position in terms of investment risk, since in the case of the deferred cash wage or salary they would still retain the investment choice at the cessation time as to whether or not they should reinvest the money in shares in the IP spin-off company. Under the employee share scenario, the investment choice is lost since the investment is already made.

Further, the deferral concession still contains the significant disincentive to taking the shares which was identified under the basic position above. This arises from the fact that the employee still faces the risk of being left with a 'quarantined' capital loss if the shares should ultimately decline in value, notwithstanding that the (unrealised) appreciation in value between acquisition and cessation time has been taxed as ordinary wage and salary income. Given the high levels of risk associated with the operations of an IP spin-off company, there is a corresponding high risk that the unrealised (but taxed) appreciation will ultimately remain unrealised, with the employee then left with a quarantined capital loss of no immediate value.

6.2 Exemption concession for employee shares

The other form of tax relief offered under Division 13A is an 'exemption concession'. This provides a tax exemption for the 'acquisition discount' on a 'qualifying share' – i.e. a share which otherwise qualifies for the deferral concession (see above) – but only if certain additional conditions are also met[40].

The exemption is capped at $1,000 per annum for an employee[41]. This immediately renders it effectively useless as an instrument for IP spin-off companies to engage employees on terms that they forgo wages and salary for shares.

To obtain the exemption, the employee must elect to be covered by the exemption for all 'qualifying shares' acquired in the year[42] and the shares must be offered on terms which also meet the following additional 'exemption conditions'[43]:

(a) The shares must be acquired subject to no forfeiture conditions.

(b) The employee must be prohibited from disposing of the shares for 3 years (or until employment ceases, if earlier).

(c) The employee share scheme must operate on a 'non-discriminatory' basis, which requires that[44]:

    (i) Shares must be offered to at least 75% of permanent employees on terms which are the same in their essential features; and

    (ii) Any associated financial assistance must be offered to at least 75% of permanent employees on terms which are the same in their essential features.

Where an employee elects for the exemption concession to apply:

(a) The 'acquisition discount' is treated as exempt income of the employee up to the limit of $1,000[45]. So, for example, if a company's shares had a market value of $1.01, it could issue in one financial year up to 1,000 shares to an employee at an issue price of one cent (meaning that the total difference between the market value and the issue price of the shares was $1,000), and the employee would be exempt from tax on that total acquisition discount of $1,000.

The employee is then treated, for capital gains tax purposes, as having acquired the share itself at that point for a cost equal to its market value at acquisition date[46]. So, on the example given, the employee would be treated as acquiring the 1,000 shares at a cost of $1.01 each. From this point, capital gains treatment applies to subsequent dealings in the shares (see above).

It can be seen that the exemption concession would not be regarded as a huge tax saving for most employees. The exemption concession does, however, have the advantage that any subsequent

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40 Sections 139BA, 139E and 139B(3) of 1936 Act.
41 Section 139BA(2).
42 Section 139E.
43 Section 139CE.
44 Section 139GF.
45 Section 139B(2), 139CC(2) and 139BA(2) of 1936 Act.
46 Section 130-80 of the 1997 Act.

appreciation in the value of the shares will be eligible for the CGT discount treatment, so long as the employee holds the shares for at least 12 months.

As noted above, the limit on the exemption means it has little practical usefulness of an IP spin-off company to offer shares in exchange for employees forgoing substantial portions of their normal cash wage or salary entitlements. In addition, the need to offer shares on a non-discriminatory basis to 75% of permanent employees raises the same kinds of practical problems for a small spin-off company as arise for the deferral concession.

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Part 7
Tax-planning solutions as an alternative to Division 13A concessions

Given the limited relief offered by the Division 13A concessions, the question arises as to whether the problems can be solved by 'self-help' in the form of tax-planning. We now turn to consider two broad tax-planning responses to the limitations in Division 13A.

7.1 "Out of the money" option plans

One approach is to issue to the employee, for a nominal price, 'out of the money' options to acquire shares at a future date for a fixed exercise price. The options are 'out of the money', in the sense that they are designed so that the exercise price is set at a price slightly higher than the market value of the shares on the date the options are issued.

This has the consequence that there should be no taxable 'acquisition discount' in relation to the options – their market value should be equal to or less than the nominal price paid by the employee, because the options are 'out of the money'. As a result:

(a) The options should not be taxable under Division 13A as ordinary income[47]. It should also be noted that, even if there is an acquisition discount on an option, Division 13A provides that the employee can elect to pay tax on that discount, but then seek a refund of that tax if the option is subsequently not exercised due to the share value subsequently falling below the exercise price[48].

(b) From this point, capital gains treatment applies to subsequent dealings in the options and any shares acquired as a result of the options. In particular:

    (i) If the option is exercised to acquire the shares, the employee will be treated as an investor acquiring the shares for a cost deemed to be equal to the sum of the initial nominal price paid for the option plus the exercise price.

    (ii) If the shares appreciate in value above that assumed exercise price, any gain on sale will be treated as a capital gain. If the shares are held for a further 12 months after the exercise of the option, only half the gain will be taxable, under the CGT discount rules.

This option arrangement thus avoids two problems with the employee share arrangements outlined above. It does not require tax to be paid on unrealised acquisition discounts, because there are no acquisition discounts. It also ensures that gains realised by the employee obtain preferential capital gains treatment rather than ordinary income treatment.

Unfortunately, in the context of IP spin-off companies, the option arrangement has certain commercial disadvantages relative to share arrangements. One is that the options are valueless unless the price of the underlying shares appreciates. A second is that employee does not, of course, obtain the legal and economic rights of a shareholder until the options are exercised. As noted by the Australian Employee Ownership Association:

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47 Section 139C(3) of the 1936 Act. It should also be noted that, even if there is an acquisition discount on an option, Division 13A provides that the employee can elect to pay tax on that discount.

48 Section 139DD of the 1936 Act.

> '*Employee owners should have the same rights as other owners.* Like them, where applicable, employee owners should be able to vote their shares, receive dividends, and be free of any artificial restriction upon the length of time they can hold shares in their employer's company'[49] (emphasis added).

A third problem is that the employee will need to obtain substantial funds to exercise the option, since he or she will need to pay an exercise price corresponding to the market value of the shares at the time the options were issue. In theory, if the shares have appreciated in value, the employee should be able to raise the funds by borrowing against the market value of the shares acquired under the option; in practice, financiers are likely to be reluctant to lend against shares in an IP spin-off company. A fourth problem is that, to obtain the benefit of the CGT discount on sale of the shares, they need to be held for at least a further 12 months after the exercise of the option.

Thus, the out of the money option plan does not extend to the employee any benefit on the form of capital gains tax treatment for shares offered in lieu of payment of salary or wages. The shares are actually paid for out of actual cash resources which the employee must obtain separately. Hence, this kind of plan has limited practical usefulness as an instrument for an IP spin-off company to offer shares in exchange for employees forgoing substantial portions of their normal cash wage or salary entitlements.

7.2 Concessional loan plans

An alternative approach is for the company to issue shares to the employee for a market value price, and then make an interest free loan to the employee of funds equal to the market price to pay for the shares.

This has the consequence that there should be no taxable 'acquisition discount' in relation to the shares because the employee is treated as acquiring them for a market value price. As a result:

(a) The shares are not taxable under Division 13A as ordinary income[50].

  (i) From this point, capital gains treatment applies to subsequent dealings in the shares. In particular:

  (ii) The employee will be treated as an investor acquiring the shares for a cost equal to the market value issue price.

  (iii) If the shares appreciate in value above that price, any gain on sale will be treated as a capital gain. If the shares are held for 12 months after the exercise of the option, only half the gain will be taxable, under the CGT discount rules.

This arrangement does not require tax to be paid on unrealised acquisition discounts, because there are no acquisition discounts. It also ensures that gains realised by the employee obtain preferential capital gains treatment rather than ordinary income treatment.

However, it has the commercial disadvantage of leaving the employee with a commercial loan obligation equal to the market value of the shares at the issue date, so that unless the share appreciates in value the employee's net investment in the company remains at nil. If the shares decline in value, the employee will be obliged to repay the loan from their own funds. In the context of a high-risk IP spin-off company, an employee may well be inclined (and well advised) not to take on this loan

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49 Australian Employee Ownership Association, 'Our Policy', Principle 5 (at www.aeoa.org.au).

50 Section 139C(3) of 1997 Act.

exposure. Further, while fringe benefits tax will not apply to the loan when it is made, even if it is interest free[51], fringe benefits tax will apply if the loan is subsequently forgiven or waived. Hence, this kind of plan again has limited practical usefulness as an instrument for an IP spin-off company.

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[51] Interest free loans to acquire shares are given a nil value for fringe benefits tax purposes because the employee would be able to deduct the interest for income tax purposes if interest was charged: see section 19 of *Fringe Benefits Tax Assessment Act 1986*.

Part 8
Suggested conceptual resolution of the problem for IP spin-off companies

It can be seen that employee shares generally raise a number of taxation problems which will be a disincentive to the adoption of employee share arrangements. These problems have lead to various tax reform proposals designed to reduce these disincentives[52]. However, the taxation problems also raise, at a more general level, interesting conceptual problems concerning the validity of traditional distinctions drawn between employees and investors in their relationships to a business enterprise, and, in particular, whether it is still valid to draw distinctions based on the legal form of the relationships, rather than economic factors such as the sharing of risk and reward.

Shares issued by IP spin off companies to employees encounter taxation problems because the shares have their origin in the employment relationship between the company and the recipient of the shares. They are *prima facie* treated as a form of employment income, rather than as a share investment, simply because they are received by reason of the legal relation of employment[53]. However, it is submitted that determination of the correct taxation treatment should not depend solely on the legal form of the relationship between the recipient and the company which is the original source of the acquisition of the shares.

Rather, the enquiry as to proper taxation characterisation of the employee shares should involve an evaluation of all the circumstances of the acquisition and holding of the shares. In particular, the question must be asked as to whether, in all the circumstances, it is appropriate to characterise the shares as employment income, rather than as share investments, for taxation purposes. Under this approach, the shares should only be treated as employment income if they can reasonably be treated as the equivalent of money wages or salary received in the capacity of employee. If they cannot be reasonably as such an equivalent, they should not be treated as employment income. They should be treated as a share investment subject to the same capital gains tax treatment as other share investments.

In considering whether the shares can reasonably be regarded as the equivalent of money wages or salary, the relationship between risk and reward is relevant. The traditional employee does not take a position of significant risk in relation to the company which rewards them for the sale of their labour (or labour time); instead they receive a guaranteed, fixed and regular cash wage of salary which is legally due and payable regardless of the economic fortunes of the enterprise. By contrast, the share investor does take a position of significant risk in relation to the company in which they acquire shares; the return on their shares is neither guaranteed, nor fixed nor regular, but rather depends wholly on the economic fortunes of the enterprise.

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52 See *Shared Endeavours, Inquiry into employee share ownership in Australian enterprises*, AGPS (2000), a report by House of Representatives Standing Committee on Employment, Education and Workplace Relations. See also Australian Chamber of Commerce and Industry, *Taxation Reform Blueprint: A Strategy for the Australian Taxation System 2004-2014* (Nov 2004), Chapter 8 (Employee Share Ownership Plans and Taxation); the policy papers of the Australian Employee Ownership Association at www.aeoa.org.au; and the policy papers of the Employee Ownership Group at http://www.eogroup.org/.

53 See ATOID 2002/888 and *Smith v. Federal Commissioner of Taxation* (1987) 164 CLR 513; 87 ATC 4883; (1987) 19 ATR 274; c.f. *Payne v. FC of T* (1996) 66 FCR 299; 96 ATC 4407; (1996) 32 ATR 516, holding that a taxpayer who received rewards under a frequent flyer program from points that were accumulated from travel as an employee did not derive employment benefits for taxation purposes, because the reward resulted from a personal contractual relationship between the employee and Qantas, and there was no relationship between the benefit granted and the employment of the employee. This relationship was absent as the employer had no part in the program and did not encourage, arrange or pay for the employee to participate in the program.

Further, in considering the appropriate characterisation, it needs to be kept in mind that preferential capital gains tax treatment is intended to apply where investments are made at risk in a company. Thus, capital gains tax treatment will be appropriate where the employee share arrangement involves the employee taking a position of substantial investment risk in relation to the company, as compared to the position of no investment risk which applies where the employee is rewarded by weekly or monthly wage and salary payments.

It is beyond the scope of this paper to consider the full implications of this argument. However, the application of this argument can be considered in the specific case of employee shares and IP spin-off companies. It is submitted that, where an IP spin-off company offers shares to an employee in substitution for a normal cash wage or salary, the employee has taken a position of substantial risk in relation to the company. The return for the contribution of their labour, and their intellectual capital, to the company is not guaranteed, fixed or regular – it is wholly dependent on the economic fortunes of the enterprise. Further, in the case of an IP spin-off company, the economic fortunes of the enterprise are themselves subject to significant risk.

As such, it can be seen that the position taken by the employee is one of substantial investment risk in relation to the company. Once this risk is recognised and evaluated, it can also be seen that it is not appropriate to treat the shares as the equivalent of money wages or salary received in the capacity of employee. The shares, in these circumstances, plainly lack the character of wage and salary income – they do not provide a guaranteed, fixed and regular return which is legally due and payable regardless of the economic fortunes of the enterprise. From this it follows that the shares should not be treated as employment income at the time of acquisition. Rather, they should be treated as a normal acquisition of a share investment, eligible for capital gains tax treatment in the same way as any other share acquisition.

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Part 9
Conclusion

The taxation problems faced by IP spin-off companies in relation to employee shares raise interesting conceptual problems concerning the validity of traditional distinctions drawn by the income tax law between employees and investors in a company. To resolve these taxation problems satisfactorily as a matter of tax policy it seems to be necessary to depart from traditional distinctions based on the legal form of the relationships, and give greater weight to economic factors such as the relationship between risk and reward, and the degree of economic risk assumed by the employee in their dealings with the company.

Employees who forgo wages and salary in exchange for shares in an IP spin-off company take a position of substantial investment risk which is analogous to the position of an ordinary share investor rather than the position of a normal employee. They agree to contribute intellectual capital to the enterprise in exchange for shares in the company. Such 'employees' can be seen, conceptually, as investors of intellectual capital, rather than sellers of labour, in relation to the spin-off company. This is the equivalent of any other form of 'at risk' investment in shares in the enterprise, and should be treated as such for tax purposes.

However, current income tax law does not treat the employee as an investor in an enterprise. Because the spin-off company is, from a formal legal perspective, the employer of the individuals who have agreed to contribute their labour, the income tax law will treat the shares received in the spin-off company as in the nature of employment income equivalent to a cash salary. This appears to be conceptually invalid. It also operates as a disincentive to employee shares and the development of IP spin-off companies. There is a solid case for reform of the tax law.

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IPRIA Working Papers

No.	Title	Author(s)
19/05	Sellers of Labour or Investors of Intellectual Capital?	*Rider*
18/05	Measuring Intangible Investment	*Hunter / Webster / Wyatt*
17/05	Perfect Price Discrimination with Costless Arbitrage	*Gans / King*
16/05	Has Investment in Start-Up Firms Driven Incumbent Innovative Strategy? Evidence from Semiconductor and Biotechnology Venture Capital Funded Firms	*Dewo / Gans / Hirschberg*
15/05	Communication in the Digital Environment: An empirical study into copyright law and digitisation practices in public museums, galleries and libraries	*Hudson / Kenyon*
14/05	A Comment on the Copyright Exceptions Review and Private Copying	*Weatherall*
13/05	The Culture of Trade Marks: An Alternative Cultural Theory Perspective	*Bosland*
12/05	Strength of Partnership as a Key Factor in Collaboration between Universities and Industry for Production of IP: A Study of Applications to the BHERT Awards	*Mann*
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10/05	Operationalizing Value-Based Business Strategy	*Gans / MacDonald / Ryall*
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08/05	Intellectual Property Strategy and Business Strategy: Connections Through Innovation Strategy	*Samson*
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