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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (2009 BUDGET MEASURES No. 2) BILL 2009

INCOME TAX (TFN WITHHOLDING TAX (ESS)) BILL 2009

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Treasurer, the Hon Wayne Swan MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
ABN	Australian Business Number
ATO	Australian Taxation Office
CGT	capital gains tax
Commissioner	Commissioner of Taxation
DASP Act	*Superannuation (Departing Australia Superannuation Payments Tax) Act 2007*
ESS	employee share scheme
FBT	fringe benefits tax
FBTAA 1986	*Fringe Benefits Tax Assessment Act 1986*
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
IT(TP)A 1997	*Income Tax (Transitional Provisions) Act 1997*
MEC	multiple entry consolidated groups
S(UMLM) Act	*Superannuation (Unclaimed Money and Lost Members) Act 1999*
TAA 1953	*Taxation Administration Act 1953*
Temporary Residents Act	*Temporary Residents' Superannuation Legislation Amendment Act 2008*
TFN	tax file number
the Regulations	*Income Tax Assessment Regulations 1997*

General outline and financial impact

Reforming the taxation of employee share schemes

Schedule 1 to this Bill and the Income Tax (TFN Withholding Tax (ESS)) Bill 2009 reform the taxation of employee share schemes by:

- replacing the current Division 13A of Part III of the *Income Tax Assessment Act 1936*;
- inserting a new Division 83A into the *Income Tax Assessment Act 1997* dealing with employee share schemes; and
- inserting a new Subdivision 14-C in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953) dealing with the employee share scheme withholding tax, and a new Division 392 in Schedule 1 to the TAA 1953 dealing with employee share scheme reporting.

Date of effect: The changes apply to shares, rights and stapled securities acquired on and after 1 July 2009.

In order to simplify the law and improve the interaction of the employee share scheme rules with other areas of the law, shares, rights and stapled securities acquired before this time will also be brought within the new rules. However, transitional arrangements will be provided to ensure the effect of the existing law is maintained for securities acquired before 1 July 2009.

Proposal announced: This measure was first announced in the 2009-10 Budget and in the Treasurer's Media Release No. 065 of 12 May 2009. Final details of the measure were announced in the Assistant Treasurer's Media Release No. 011 of 1 July 2009.

Financial impact: This measure is estimated to have the following revenue impact over the forward estimate period:

2009-10	***2010-11***	***2011-12***	***2012-13***	***Total***
Nil	$35m	$45m	$55m	$135m

Compliance cost impact: Low.

Non-commercial losses

Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* to tighten the application of the non-commercial losses rules in relation to individuals with an adjusted taxable income of $250,000 or more. These amendments will prevent high income individuals from offsetting deductions from non-commercial business activities against their salary, wage or other income.

Date of effect: These amendments apply to the 2009-10 income year and later income years.

Proposal announced: This measure was announced in the 2009-10 Budget and in the Treasurer's Media Release No. 067 of 12 May 2009.

Financial impact: This measure will have these revenue implications:

2009-10	***2010-11***	***2011-12***	***2012-13***
Nil	$330m	$240m	$130m

Compliance cost impact: Low.

Superannuation — Payment of lost member accounts to the Commissioner of Taxation

Schedule 3 to this Bill amends the *Superannuation (Unclaimed Money and Lost Members) Act 1999* to require superannuation providers to transfer the balance of a lost member's account to the Commissioner of Taxation (Commissioner) where: the balance of the account is less than $200; or the account has been inactive for a period of five years and the provider is satisfied it will never be possible to pay an amount to the member.

Date of effect: These amendments apply in relation to the last unclaimed money day occurring before 1 July 2010 and later unclaimed money days.

Proposal announced: This measure was announced in the 2009-10 Budget.

Financial impact: These amendments result in a gain to revenue estimated at $238 million over the forward estimates period. These amendments are also expected to increase government expenditure by $8.4 million over this period.

	2010-11	***2011-12***	***2012-13***
Revenue	$187.3m	$39.2m	$11.5m
Related expense	$3.6m	$3.1m	$1.8m

These amendments are expected to have a moderate ongoing financial impact in subsequent years.

Compliance cost impact: Low to medium. Superannuation funds will need to ensure their systems can enable eligible lost member accounts to be transferred to the Commissioner. There should be long term savings for funds as they will no longer need to administer or apply member protection to those accounts transferred to the Commissioner.

Chapter 1
Reforming the taxation of employee share schemes

Outline of chapter

1.1 Schedule 1 to this Bill and the Income Tax (TFN Withholding Tax (ESS)) Bill 2009 reform the taxation of employee share schemes by:

- replacing the current Division 13A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936);
- inserting a new Division 83A into the *Income Tax Assessment Act 1997* (ITAA 1997) dealing with employee share schemes; and
- inserting a new Subdivision 14-C in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953) dealing with the employee share scheme withholding tax, and a new Division 392 in Schedule 1 to the TAA 1953 dealing with employee share scheme reporting.

Context of amendments

History

1.2 Under the general income tax law, if an employee is provided with shares or rights under an employee share scheme, any discount that the employee receives by acquiring the shares or rights below the market price is a benefit relating to employment and so would usually be considered income of the employee. However, the fringe benefits law would also assess that discount (generally as a property fringe benefit under Division 11 of Part III of the *Fringe Benefits Tax Assessment Act 1986*). Where fringe benefits tax (FBT) applies, the income tax law would treat the discount as non-assessable non-exempt income to avoid double taxing the benefit.

1.3 However, Division 13A of Part III of the ITAA 1936 provides a specific regime which brings the discount to account as assessable income

in the year the employee acquires the share or right. Double taxation is avoided because the fringe benefits law excludes benefits assessed under Division 13A.

1.4 The law governing the taxation of benefits of employee share schemes was previously located in section 26AAC of the ITAA 1936, which applied from 1974. Generally, this section applies to the acquisition of a share or right before 28 March 1995. In 1974, section 26AAC replaced paragraph 26(e) of the ITAA 1936 as the basis for taxing benefits acquired under an employee share scheme following a court case which highlighted situations where paragraph 26(e) was found to be insufficient.

1.5 Division 13A was introduced in 1995 to counter the arrangements which exploited the then existing legislation. Division 13A sought to ensure that the concessions available were directed at employee share schemes which encourage investment by employees in their employer company, or in their employer company's holding company, and which are broadly available to all permanent employees.

Outline of existing law

1.6 Under the existing arrangements, employees who take part in an employee share scheme are required to pay tax on any discount on the market value of a share or right they receive from their employer. This is currently the case in relation to both qualifying share schemes, that are eligible for concessional taxation, and non-qualifying share schemes.

1.7 Division 13A starts by taxing all discounts upfront. However, an employee participating in a 'qualifying' employee share scheme can, subject to certain conditions, choose one of two tax concessions on the discount they receive — the 'upfront concession' or the 'tax-deferred concession'.

1.8 An employee participating in a qualifying employee share scheme that satisfies certain conditions can elect to be taxed on the discount in the year they acquire the shares or rights, and receive the benefit of a reduction of the discount by up to a $1,000 (the 'upfront concession'). The reduction is a tax concession.

1.9 Under the upfront concession, any subsequent capital gains on the disposal of the shares or rights are subject to capital gains tax (CGT), and the 50 per cent CGT discount may apply.

1.10 If an employee participating in a qualifying employee share scheme does not make an election to be taxed upfront, they receive the benefit of the 'tax-deferred concession'.

1.11 Under the tax-deferred concession, there is no $1,000 exemption but the employee defers paying tax on the discount until the 'cessation time'. A cessation time occurs at the earliest of the following:

- when the employee sells the shares or exercises the rights;
- when the employment ceases;
- ten years after the shares or rights were acquired; and
- the later of:
  - when restrictions on sale are lifted; and
  - when forfeiture conditions cease to have effect.

1.12 Any increase in value of the shares or rights (before the cessation time) is included in assessable income at the cessation time under Division 13A. Therefore, the CGT discount is not available to gains accrued before the cessation time. If a share or right is not sold within 30 days of the cessation time, any capital gains accrued after the cessation time remain subject to CGT, including the CGT discount if available.

1.13 In comparison, if the shares or rights are issued under a non-qualifying scheme the employee is taxed on the discount when they acquire the shares or rights. This means they do not enjoy the tax benefits associated with qualifying employee share schemes.

Budget announcement and changes

1.14 The Treasurer announced in the 2009 Budget that the Government will better target eligibility for the employee share scheme tax concessions and reduce opportunities for tax avoidance. The new measures will also protect Commonwealth revenues needed to support jobs and invest in vital nation-building in the face of the global recession.

1.15 The Budget savings measure was designed to improve horizontal equity in the tax system by treating all forms of remuneration more consistently, to target employee share scheme tax concessions more closely to low and middle income earners, and to reduce the scope for losses to the Commonwealth revenue through tax evasion and avoidance.

1.16 The Budget measure announced that all discounts on shares and rights provided under an employee share scheme would be assessed in the income year in which the shares and rights are acquired.

1.17 Responding to concerns expressed by stakeholders following the Budget announcement, the Government issued a public consultation paper which sought to better understand those concerns, and canvas a number of options to improve the taxation of employee share schemes.

1.18 On 1 July 2009, the Government issued a Policy Statement setting out the taxation of employee share schemes. This statement contained changes to the Budget announcement which took account of industry concerns expressed in consultation, while still addressing the acknowledged problems of tax evasion and tax avoidance.

1.19 Further public consultation was undertaken on an exposure draft of the legislation and explanatory materials.

1.20 The Government has also asked the Board of Taxation to consider two further issues raised in consultation.

1.21 The Board of Taxation will consider and report to Government how best to determine the market value of employee share scheme benefits. The Board of Taxation will also consider whether employees of start-up, research and development and speculative-type companies should benefit from a tax deferral arrangement despite not being subject to a real risk of forfeiture. The Board of Taxation will report to Government on these issues by the end of February 2010.

Summary of new law

1.22 In order to simplify the existing arrangements, the new rules have been rewritten into the ITAA 1997.

Objects

1.23 These Bills reform the taxation of employee share schemes.

1.24 The employee share scheme tax rules tax the value of benefits received by employees under employee share schemes to ensure taxpayers are taxed consistently regardless of the forms of remuneration they receive.

1.25 However, the rules also specifically aim to improve the alignment of employee and employer interests. In recognition of the

economic benefits derived from employee share scheme arrangements, the rules provide for tax concessions for employees participating in employee share schemes.

1.26 Tax support is provided on the grounds that aligning the interests of employees and employers encourages positive working relationships, boosts productivity through greater employee involvement in the business, reduces staff turnover and encourages good corporate governance.

Scope of the employee share scheme tax law

1.27 An ***employee share scheme*** provides employees with a financial interest in the company they work for through the distribution of shares in that company.

1.28 An ***ESS interest*** is defined as a beneficial interest in a share in a company; or a beneficial interest in a right to acquire a beneficial interest in a share in a company. For simplicity in expression, throughout the chapter references may simply be to shares or rights.

1.29 Generally, benefits provided by an employer to an employee in respect of their employment would be taxed under the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986).

1.30 Consistent with the current law, the new law specifically exempts 'ESS interests' acquired under an employee share scheme from being taxed as a fringe benefit under the FBTAA 1986.

1.31 Sometimes it is unclear whether a right to an employment benefit will be received in the form of an ESS interest, or it is unclear how many ESS interests will be received. If it becomes clear that the right to the employment benefit will be received in a definite number of ESS interests, it is taxed under the employee share rules as though it were always clearly an ESS interest. This ensures that employment benefits provided in the form of discounted shares or rights to shares are taxed consistently.

1.32 The employee share scheme tax laws do not apply if the employee is not provided with 'ESS interests'.

1.33 Once an ESS interest has been taxed under the employee share scheme rules, it is subsequently taxed consistent with other capital assets, most likely under the CGT regime, but possible under other regimes such as the trading stock rules.

Upfront taxation

1.34 Generally, any discount to the market value of ESS interests in shares or rights provided under an employee share scheme is taxed upfront (that is, on acquisition). That means that the market value of the discount must be included in an employee's assessable income for that income year.

1.35 A $1,000 tax exemption is available to taxpayers participating in an employee share scheme who pay tax upfront, if they have a taxable income (after adjustments) of $180,000 or less, and the employee and the scheme meet certain conditions.

1.36 The other conditions for the upfront concession are:

- the employee must be employed by the company offering the scheme, or one of its subsidiaries;
- the scheme must be offered in a non-discriminatory way to at least 75 per cent of Australian resident permanent employees with three or more years service;
- the shares or rights provided must not be at real risk of forfeiture;
- the ESS interests offered under the scheme must relate to ordinary shares;
- the shares or rights must be required to be held by the employee for three years or until the employee ceases employment; and
- the employee must not receive more than 5 per cent ownership of the company, or control more than 5 per cent of the voting rights in the company, as a result of participating in the scheme.

Deferred taxation

1.37 Although the economic value embodied in employee share scheme shares and rights is equivalent to any other form of employee compensation and should generally be taxed upfront in the same manner, exceptions to this general principle are made for two forms of employee share scheme — schemes where the ESS interests are at real risk of forfeiture, and schemes where the ESS interests are acquired under certain salary sacrifice arrangements.

1.38 Unlike the current law, whether a share or right is subject to taxation upfront or at a later time depends on the structure of the scheme and not an election of the employee. This reduces the tax avoidance problems associated with the existing election arrangements, because the employer can advise the employee and the Australian Taxation Office (ATO) of the taxation arrangements applying to that scheme.

1.39 For the deferred tax rules to apply:

- the relevant ESS interests must be acquired at a discount under an employee share scheme, relate to ordinary shares and be subject to a real risk of forfeiture; or

- the relevant ESS interests must be acquired under a salary sacrifice arrangement, and the employee must receive no more than $5,000 worth of shares under those arrangements in an income year.

1.40 Certain other conditions must also be met (see paragraphs 1.152 to 1.188).

ESS interests at real risk of forfeiture

1.41 Deferral of taxation is considered the appropriate treatment in situations where there is a real risk that the benefits of shares or rights may never be realised because the ESS interests may be forfeited.

1.42 An ESS interest is at real risk of forfeiture if a reasonable person would consider that there is a real risk that the employee would lose or forfeit the interest or never receive it, other than by selling or exercising it, by intentionally taking no action to realise the benefit, or through the market value of the ESS interest falling to nil.

1.43 Providing for deferral of tax in these situations recognises that the employee may never have a chance to realise the economic value of the ESS interest, and that having employee remuneration 'at risk' in this manner is consistent with the purpose of concessionally taxing employee share schemes, to align the interests of employees and employers.

ESS interests provided through a salary sacrifice scheme

1.44 The deferral arrangements also allow for ESS interests received at a 100 per cent discount through a salary sacrifice arrangement to be subject to deferred taxing treatment. The risk of forfeiture is not necessary to get deferred taxation treatment through a salary sacrifice scheme.

1.45 To be eligible for deferred taxation a salary sacrifice scheme must relate to shares (not rights), the employee must receive the shares, for no consideration (discount per share provided through the arrangement is equal to the market value of the share), and the employee must receive no more than $5,000 worth of shares. Certain other conditions must also be met.

1.46 Providing for deferred tax in the case of employee share schemes involving salary sacrifice arrangements ensures that certain employees utilising similar arrangements under the existing law will continue to be able to access these arrangements with minimal disruption. This encourages the broad availability of, and participation in, employee share schemes, and the broad alignment of the interests of employees and employers in Australia.

1.47 This is particularly the case for low-to-middle employees, for whom $5,000 of benefits is likely to have a greater significance.

The ESS deferred taxing point

1.48 When tax on an employee share scheme discount is deferred, it is deferred until the 'ESS deferred taxing point' occurs.

1.49 The deferred taxing point for shares is the earliest of when:

- there is no real risk that the employee will forfeit the share, or lose the share other than by disposing of it; and there are no genuine restrictions preventing disposal; or
- when the employee ceases the employment in respect of which they acquired the share; or
- seven years after the employee acquired the share.

1.50 The ESS deferred taxing points for rights are based on similar principles, with some additional conditions to account for situations which would only arise in relation to rights (for example, because they can be exercised as well as disposed of).

Employee share schemes and capital gains tax

1.51 ESS interests are exempted from CGT (in most cases) until the interest has been taxed under the employee share scheme rules. As the employee share scheme rules are intended to be the primary taxing regime for 'ESS interests' during the period of deferred taxation, application of the CGT provisions would potentially result in double taxation.

1.52 Once an ESS interest has been taxed under the employee share scheme rules, it is subsequently taxed consistent with other capital assets, most likely under the CGT regime, but possible under other regimes such as the trading stock rules.

1.53 The new employee share scheme rules ensure employees participating in employee share schemes are taxed consistently regardless whether the scheme utilises a trust structure.

Protecting the integrity of employee share schemes

1.54 The new rules are designed to protect the integrity of the taxation of employee share schemes. A number of integrity provisions in the current law are reproduced, and a number of new integrity provisions are introduced.

Interests provided to associates

1.55 The new law treats employee share scheme interests provided to associates of employees in relation to an employee's employment as though the interest was in fact acquired by the employee rather than the associate. This is similar to the treatment under the current law.

1.56 This provision is designed to ensure that arrangements are not artificially constructed to avoid the employee share scheme tax rules, or to lessen a tax liability incurred in relation to 'ESS interests', by providing benefits to associates of an employee.

Interests in a trust

1.57 The new law is designed to ensure that, when an employee has a beneficial interest in shares in an employee share trust, that they will be taxed as though they were the legal owner of those shares. This is so that employees cannot lessen, delay or avoid their tax liability by interposing a trust.

1.58 The rules essentially seek to ignore the interposed trust for tax purposes.

Employer reporting

1.59 The new law requires employers who provide ESS interests to report certain information to the Commissioner of Taxation (Commissioner), to enable the Commissioner to ensure that the employee share scheme tax law is being complied with.

1.60 These reporting requirements boost the integrity of the taxation of share schemes, addressing concerns that the current employee share scheme rules are not being complied with, that the Commissioner is not in a position to know the full extent of that non-compliance, and enabling the Commissioner to conduct data matching activities.

1.61 The reporting requirements also allow the Commissioner to pre-fill tax returns to assist employees with their tax obligations.

1.62 The legislation outlines some of the particular information that the Commissioner may require in the approved form. This is provided to better illustrate the intent of the employer reporting requirements, and to provide some guidance to employers and employees as to the sort of information the Commissioner might require.

1.63 The legislative guidance that is provided on what the Commissioner may require in the approved form does not in any way limit the information that the Commissioner may or may not require.

Withholding tax

1.64 The new law introduces a withholding tax, applicable in limited circumstances, to ensure the integrity of the taxation of employee share schemes.

1.65 Withholding tax is payable if an employer provides discounted shares or rights to an employee, and that employee has not quoted their tax file number (TFN) or their Australian Business Number (ABN) to the employer by the end of the income year.

1.66 An employee refusing to provide their employer with a TFN or ABN (as the case requires) undermines the new law relating to employer reporting requirements, which are important in ensuring the tax integrity of employee share scheme arrangements.

1.67 It is rare for an employee to refuse to provide their employer with a TFN, so it is not expected that the withholding tax will be commonly levied.

Interests may relate to past or prospective employers

1.68 An employee share scheme is a scheme under which employees (including past or prospective employees) of a company acquire ESS interests in relation to their employment.

1.69 The extension to past or prospective employees is an integrity measure to ensure that arrangements are not deliberately designed to occur

before or after employment in order to avoid the employee share scheme rules. This is consistent with the general treatment of employment benefits elsewhere in the tax law, such as in the FBTAA 1986.

Deduction by employers

1.70 Under the general income tax law, an employer would not be entitled to a deduction for directly providing shares or rights to shares in itself to its employees.

1.71 In order to encourage the provision of shares or rights under certain employee share schemes, a limited specific deduction is provided to employers. An employer can deduct an amount for shares or rights they provide to employees under an employee share scheme if the scheme meets the conditions for an employee to receive the upfront concession. The income test for the upfront concession is disregarded when calculating as employer's eligibility to claim a deduction.

1.72 A general deduction may be available in relation to the indirect provision of securities to employees under an employee share scheme. An employer may provide money to an employee share trust for the purpose of providing its employees with securities in itself. The employee share trust may acquire the securities by buying them on the market or by participating in a share issue by the employer.

1.73 The deduction would generally occur in the income year in which the employer incurred the loss or outgoing. However, such an arrangement may allow an employer to artificially bring forward future deductions by making contributions to the trust that are in excess of its requirements under an employee share scheme. To prevent an artificial bring forward of these deductions, the employee share scheme rules delay the deduction until the employee acquires an ESS interest.

Foreign employment

1.74 Consistent with the treatment of most other types of income, whether an amount is included in a taxpayer's assessable income under the new employee share scheme rules will depend on the taxpayer's residency status and the source of the income.

1.75 There have been some changes to the treatment of foreign employment to reflect changes recently made to the foreign employment tax exemption in section 23AG of the ITAA 1936.

Refund of tax for forfeited shares

1.76 The new law provides for a refund of tax paid in relation to discounted ESS interests in certain circumstances where those interests are forfeited and the employee has been taxed on the discount.

1.77 These provisions provide a refund of tax in circumstances where the employee had no choice but to forfeit the ESS interest, except when that choice was to cease employment, and where the conditions of the scheme were not constructed to protect the employee from market risk.

1.78 Under such circumstances, the forfeited ESS interest is treated as never having been acquired, and the taxpayer can claim a refund of income tax by seeking an amendment to their income tax assessment to remove income previously included in their assessable income. There is no time limit on amending an assessment to exclude an amount from a taxpayer's assessable income for a share interest which is forfeited, or for a right which was lost without being exercised.

1.79 As the refund provisions are not intended to protect the employee from downside market risk, a refund will not be available where the share interest is forfeited due to a choice of the employee (except when that choice was to cease employment), or a condition of the scheme which has the direct effect of protecting the employee from market risk.

Comparison of key features of new law and current law

New law	*Current law*
Upfront taxation is the default position. Deferral of tax will be limited to schemes which: • require that any benefits provided are at real risk of forfeiture and meet certain other conditions; or • are provided through a salary sacrifice arrangement offering no more than $5,000 worth of benefits to an employee, and where – the rules of the scheme explicitly state that tax will be deferred; and – the scheme and the employee meet certain other conditions.	Upfront taxation is the default position. An employee participating in a qualifying scheme can, subject to certain conditions, choose to defer tax or pay tax upfront.

New law	*Current law*
Eligibility for the upfront or deferred tax concession is based on the characteristics of the employee share scheme.	An employee may elect between the upfront or deferred tax concession if they acquire 'qualifying' shares or rights.
Employees with a taxable income (after adjustments) of less of than $180,000 will receive the upfront concession and not pay tax on the first $1,000 of discounts received, if the scheme meets certain conditions.	Employees in a qualifying scheme can elect to be taxed upfront and not pay tax on the first $1,000 of discounts received. There is no means testing.
In schemes where the tax is deferred, the taxing point is the earliest of: • when there is no risk of forfeiture of the benefits and any restrictions on the sale or exercise are lifted; • when the employee ceases employment; or • seven years after the shares or rights were acquired.	Where an employee has chosen to defer tax, the taxing point is the earliest of: • when restrictions on sale are lifted; • when the employee sells the shares or exercises the options; • when the employee ceases employment; or • ten years after the shares or rights were acquired.
An employee is eligible for a refund of tax on forfeited shares and rights if the forfeiture was not the result of: • a choice of the employee (except a choice to leave employment); or • a condition of the scheme that protects the employee against a fall in market value.	An employee is eligible for a refund of tax on forfeited rights only (not shares). The refund is available if the employee loses the right without having exercised it.
Employers are subject to annual reporting requirements.	No equivalent.
A limited form of withholding tax applies in cases where an employee fails to provide their employer with a TFN or ABN at the taxing point.	No equivalent.

Detailed explanation of new law

1.80 Schedule 1 to this Bill and to the Income Tax (TFN Withholding Tax (ESS)) Bill 2009 reforms the taxation of employee share schemes. It also rewrites Division 13A from the ITAA 1936 into Division 83A of the ITAA 1997.

1.81 Rewriting the existing provisions into the ITAA 1997 provides an opportunity to simplify and improve the readability of the provisions.

1.82 References in this explanation are to the ITAA 1997 unless otherwise stated.

Objects of taxing employee share schemes

1.83 Any discount that the employee receives by acquiring an ESS interest below the market price is a benefit relating to employment, similar to salary or wages, and so would usually be considered income of the employee. These amendments tax the value of that discount, to ensure employees are taxed consistently regardless of the form of remuneration they receive. ***[Schedule 1, item 1, section 83A-1]***

1.84 However, the employee share scheme tax rules also specifically aim to improve the alignment of employee and employer interests.

1.85 In recognition of the economic benefits derived from employee share scheme arrangements, the rules provide tax concessions for employees participating in employee share schemes. ***[Schedule 1, item 1, paragraph 83A-5(b)]***

1.86 Tax support is provided on the grounds that aligning the interests of employees and employers encourages positive working relationships, boosts productivity through greater employee involvement in the business, reduces staff turnover and encourages good corporate governance.

1.87 Taxing discounts in the income tax system means that the employee pays tax on the discount at their marginal tax rate. If this was not the case, the discount would instead be subject to FBT, which may be at a higher rate. ***[Schedule 1, item 1, paragraph 83A-5(a)]***

1.88 Employees who pay tax upfront may receive an upfront tax concession. The upfront tax concession reduces the amount of a discount that an employee pays tax on, if they are a low or middle income earner and the scheme meets certain conditions (see paragraphs 1.105 to 1.123).

1.89 Alternatively, employees may receive a tax concession in the form of a deferral of tax. If the scheme and the employee meet certain conditions, the employee will defer tax on any discount to a later period (see paragraphs 1.137 to 1.188).

Scope of the employee share scheme tax law

1.90 An ***employee share scheme*** provides employees with a financial interest in the company they work for through the distribution of shares or rights to shares in that company, or subsidiaries of that company. ***[Schedule 1, item 1, subsection 83A-10(2)]***

1.91 Whether or not a company is a ***subsidiary*** of another company is determined in the same way it is determined under the *Corporations Act 2001*. This test relates to the holding company's ability to control the subsidiary company.

1.92 An ***ESS interest*** is defined as a beneficial interest in a share in a company; or a beneficial interest in a right to acquire a beneficial interest in a share in a company. For simplicity in expression, throughout the chapter references may simply be to shares or rights. ***[Schedule 1, item 1, subsection 83A-10(1)]***

1.93 Generally, benefits provided by an employer to an employee in respect of their employment would be taxed under the FBTAA 1986.

1.94 Consistent with the current law, the new law specifically exempts ESS interests acquired under an employee share scheme from being taxed as a fringe benefit under the FBTAA 1986. ***[Schedule 1, item 8, paragraphs 136(1)(h) and (ha)]***

1.95 ESS interests to which the employee share scheme rules apply are also exempted from being taxed as benefits provided in respect of employment, or non-cash business benefits. ***[Schedule 1, item 11, subsection 21A(7) of the ITAA 1936 and item 23, paragraph 15-2(3)(e)]***

Example 1.1: Employee share scheme

Daniel is employed by Blackbooks Co, and as a part of Daniel's total employment remuneration package, Blackbooks Co provides Daniel with discounted shares in Blackbooks.

Providing the scheme meets certain criteria, the shares that Daniel receives are ESS interests, provided under an employee share scheme.

As such, Daniel's shares will be taxed under the employee share scheme tax laws, and not taxed under the FBTAA 1986.

1.96 Sometimes it is unclear at the time of acquisition whether a right to an employment benefit will be received in the form of an ESS interest, or it is unclear how many ESS interests will be received at the time the right is granted. If and when it becomes clear that the right to the employment benefit will be received in a definite number of ESS interests,

it is taxed under the employee share scheme rules as though it were always clearly an ESS interest. See paragraphs 1.367 to 1.372 for further discussion of these types of benefits.

1.97 This provision would apply, for example, to an employment benefit that is a right to an indeterminate number of shares, or to a benefit that may be received in shares, in cash, or in some other form. The provision ensures that employment benefits provided in the form of discounted shares or rights to shares are taxed consistently.

1.98 The employee share scheme tax laws do not apply if the employee is not provided with ESS interests.

1.99 The employee share scheme rules only apply to ESS interests acquired at a discount. ***[Schedule 1, item 1, subsection 83A-20(1)]***

1.100 Once an ESS interest has been taxed under the employee share scheme rules, it is subsequently taxed consistent with other capital assets, most likely under the CGT regime, but possible under other regimes such as the trading stock rules.

Upfront taxation (inclusion of discount in assessable income on acquisition)

Upfront taxation is the default position

1.101 Generally, any discount to the market value of ESS interests in shares or rights provided under an employee share scheme is taxed upfront on acquisition. That means that the value of the discount must be included in an employee's assessable income for that income year. ***[Schedule 1, item 1, section 83A-15 and subsection 83A-25(1)]***

1.102 The discount is the market value of the ESS interests *less* any consideration paid or to be paid by the employee.

Example 1.2: Inclusion of a discount in assessable income

> Liz is employed by Pink Boats Inc. She receives Pink Boat shares with a market value of $100,000 for $50,000 of her money under an employee share scheme. This means that she has received a discount of $50,000, which will be included in her assessable income upon her acquisition of the ESS interests.

1.103 ESS interests provided under an employee share scheme will be taxed upfront unless the interest was acquired through a scheme that meets the conditions for deferred taxation (or the interest has already effectively been taxed under the employee share scheme rules).

1.104 An employee may acquire an interest that has already in effect been taxed, if for example, they exercise a right to acquire a share that was already subject to tax under the employee share scheme rules. In this situation they should not be taxed twice, simply because they have undertaken a multi-step process to acquire the share. ***[Schedule 1, item 1, subsection 83A-20(2)]***

1.105 Consistent with the treatment of most other types of income, whether an amount is included in a taxpayer's assessable income under the new ESS rules will depend on the taxpayer's residency status and the source of the income (paragraphs 1.347 to 1.366). ***[Schedule 1, item 1, subsection 83A-25(2)]***

Market value

1.106 By default, the ordinary meaning of market value is used for determining the value of ESS benefits. The expression market value is used with its ordinary meaning, however, in some cases that meaning is affected by the rules in Subdivision 960-S of the ITAA 1997.

1.107 The new employee share scheme rules use the ordinary meaning of market value as this meaning is used for almost all other tax purposes, and the increased flexibility that this provides means that taxpayers are able choose a valuation methodology that fits their circumstances and has the lowest compliance costs associated with it. The ATO publishes material on working out market value which can be found in the ATO's guide *Market value for tax purposes*.

1.108 Subdivision 960-S provides that any conditions and restrictions that prevent a taxpayer from converting the ESS interest into money are ignored in calculating market value (see section 960-410 of the ITAA 1997).

1.109 This Schedule introduces a new rule in to Subdivision 960-S to make it clear that when an amount of which market value is a component is referred to in the law, such as the amount of a discount, the rules in Subdivision 960-S apply to calculating the market value component of that calculation. ***[Schedule 1, item 66, section 960-415]***

1.110 The method for calculating the value of an ESS interest can also be specified by regulation in the *Income Tax Assessment Regulations 1997* (the Regulations). If the Regulations specify a specific amount, taxpayers must use this amount instead of the market value in relation to the interest. The Government proposes that the existing rules in relation to unlisted rights be replicated in the Regulations as an interim measure until the Board of Taxation completes its review on how best to determine the market value of employee share scheme benefits. ***[Schedule 1, item 1, section 83A-315]***

1.111 The Regulations may give a choice between using market value and a specified amount.

1.112 The valuation rules in the current law are inflexible and often result in compliance costs for taxpayers, particularly those with unlisted shares. However, taxpayers could continue to apply the existing detailed methodologies in the current employee share scheme rules as these would fall within the scope of those methodologies the ATO currently considers acceptable under the general rules.

1.113 The general valuation rules for unlisted shares mean that taxpayers will no longer be obliged to use an auditor if they can determine (and sufficiently justify) the market value appropriately without one.

The upfront tax concession

1.114 Employees who pay tax upfront may receive the upfront tax concession, if they are low or middle income earners and the employee and the scheme meet a number of conditions. ***[Schedule 1, item 1, section 83A-35]***

1.115 The upfront concession provides that an employee does not include a discount on ESS interests in their assessable income if the value of the combined discounts is $1,000 or less. If the discounts are greater than $1,000, they may reduce the amount they include in their assessable income by $1,000 (meaning that they are assessed on the excess over $1,000). ***[Schedule 1, item 1, subsection 83A-35(1) and paragraph 83A-35(2)(a)]***

Income test

1.116 The new law introduces an income test for the upfront concession to restrict eligibility to low and middle income earners.

1.117 Employees are not eligible for the upfront concession if their taxable income for the year, after adjustments, is greater than $180,000. Taxable income is adjusted by adding an employee's reportable fringe benefits, reportable superannuation contributions and total net investment loss for the year. This ensures that the test uses a more complete calculation of an individual's income than taxable income alone. ***[Schedule 1, item 1, paragraph 83A-35(2)(b)]***

Example 1.3: Employee is eligible for upfront concession

Matt is employed by Apple Bank Pty Ltd, and acquires shares in Apple Bank at a $1,500 discount to their market value under an employee share scheme. The scheme is not eligible for deferral.

When the Commissioner assesses Matt's income tax for the year, his taxable income adjusted by reportable fringe benefits, reportable superannuation contributions and total net investment loss is $80,000 (this calculation disregards any application of the upfront discount).

If Matt and Apple Bank's scheme meets the other conditions, Matt will receive the upfront concession, and will reduce the amount of the discount included in his assessable income by $1,000. He will still include the remaining $500 in his assessable income.

Example 1.4: Employee is not eligible for upfront concession

Liam is employed by Starstruck Co, and acquires shares in Starstruck Co at a $1,000 discount to their market value through an employee share scheme. The scheme does not meet the conditions for deferral.

When the Commissioner assesses Liam's income tax for the year, his taxable income adjusted by reportable fringe benefits, reportable superannuation contributions and total net investment loss is $200,000.

Although Liam and Starstruck Co's scheme may meet the other conditions to access the upfront concession, Liam's income is too high to receive the upfront concession. He must include the full amount of the discount in his assessable income for that year.

Must be employed

1.118 The upfront concession is only available if, at the time of acquiring the interest, the employee is employed by the company offering the scheme, or one of its subsidiaries. ***[Schedule 1, item 1, subsection 83A-35(3)]***

1.119 This ensures that the concession only applies in situations where there is the necessary employment relationship to align employer and employee interests.

Scheme must relate to ordinary shares

1.120 The ESS interests offered under the scheme must relate to ordinary shares. ***[Schedule 1, item 1, subsection 83A-35(4)]***

1.121 Shares that are not ordinary shares, such as preference shares, may have less 'risk' associated with them. For example, they may pay a more stable income stream or have priority over ordinary shares in the event of bankruptcy. They are therefore less likely to align the employee's interest with that of the company.

Scheme must be non-discriminatory

1.122 To encourage the wide availability of employee share schemes and the associated productivity benefits, the scheme must be operated on a

non-discriminatory basis. This means that the scheme must be available to at least 75 per cent of Australian resident permanent employees of the employer with three years service (whether continuous or non-continuous service). ***[Schedule 1, item 1, subsection 83A-35(6)]***

1.123 To be non-discriminatory the essential features of the employee share scheme offer must be the same for least 75 per cent of Australian resident permanent employees of the employer with three years service. The essential features of the scheme include:

- the consideration required to be paid by the employee to acquire the ESS interests;
- the number or value of the ESS interests offered to each employee;
- the time for acceptance of the offer; and
- the steps taken for the circulation of information about the offer.

1.124 While the non-discriminatory requirement is to encourage schemes to be available as widely as possible, the scheme is only required to be offered to *permanent* employees with three years service, and only to *75 per cent* of permanent employees with three years service, because it may be difficult in practice to offer the scheme to all employees (for example, casual employees).

1.125 The scheme is only required to be offered to 75 per cent of *Australian resident* permanent employees to ensure employers with a significant percentage of foreign employees can offer employee share schemes to their Australian employees without undue complexity.

Shares or rights provided must not be at real risk of forfeiture

1.126 The ESS interests provided through the scheme must not be at real risk of forfeiture. ***[Schedule 1, item 1, subsection 83A-35(7)]***

1.127 An ESS interest is at real risk of forfeiture if a reasonable person would consider that there is a real risk that the employee would lose or forfeit the interest or never receive it, other than by selling or exercising it, by intentionally taking no action to realise the benefit, or through the market value of the ESS interest falling to nil. For more discussion of real risk of forfeiture, see paragraphs 1.155 to 1.162.

1.128 Subject to some limitations, it is considered appropriate for tax to be deferred on ESS interests that the employee may never in fact receive.

Minimum holding period

1.129 The ESS interest provided cannot be disposed of for three years, unless the employee ceases to be employed at an earlier time. ***[Schedule 1, item 1, subsection 83A-35(8)]***

1.130 An employee is considered to have ceased employment when they are no longer employed either by their employer, a holding company of their employer, or a subsidiary of either of them. ***[Schedule 1, item 1, section 83A-330]***

1.131 This minimum period ensures that the concession is only provided where there is sufficiently lengthy alignment of interests between the employee and employer. If the minimum holding period were not in place an employee could access the upfront tax concession, effectively receiving $1,000 in untaxed remuneration, and immediately sell the ESS interest for cash. This is not consistent with the intended aim of offering the tax concession in order to align employee and employer interests.

1.132 A situation in which an employee ceases employment primarily to avoid the employee share scheme rules, such as the requirement for a minimum holding period, only to recommence employment with the same employer shortly after, will likely be subject to the general anti-avoidance rules.

Employee must not have significant ownership or voting rights

1.133 The interest provided to an employee must not result in the employee having effective ownership of greater than 5 per cent of their employer, and not controlling more than 5 per cent of the maximum voting rights in the employer. ***[Schedule 1, item 1, subsection 83A-35(9)]***

1.134 This provision encourages the benefits of the employee share scheme to be spread widely among employees. The concession is intended to encourage employees with small or no ownership in their employer to take up an interest in the company. It is considered that if one employee owns more than 5 per cent of the voting rights, interests between the company and that shareholder are already aligned, and no tax concession is appropriate or warranted.

1.135 Further, this acts as an integrity rule that prevents taxpayers from misapplying the concession in order to buy a business or indirectly access company profits through the employee share scheme rules. The

concession is intended to apply in respect of the employee/employer relationship and not in relation to the company/shareholder relationship.

1.136 The 5 per cent rule is administered on an employee by employee basis. That is, any individual employee breaching the 5 per cent rule will make that employee ineligible for the upfront exemption, but have no impact on other employees participating in the scheme.

Deferred taxation (the deferred inclusion of a gain in assessable income)

Deferred taxation

1.137 Although the economic value embodied in employee share scheme shares and rights is equivalent to any other form of employee compensation and should generally be taxed upfront in the same manner, exceptions to this general principle are made for two forms of employee share scheme — schemes where the ESS interests are at real risk of forfeiture, and schemes where the ESS interests are acquired under a salary sacrifice arrangement. ***[Schedule 1, item 1, section 83A-100]***

1.138 Unlike the current law, whether a share or right is subject to taxation upfront or at a later time depends on the structure of the scheme and not an election of the employee. This reduces the tax avoidance problems associated with the existing election arrangements.

1.139 Removing the election also makes it easier for employers to comply with the new reporting requirements (see paragraphs 1.281 to 1.297).

1.140 For the deferred tax rules to apply, the relevant ESS interests must be acquired at a discount under an employee share scheme, be subject to a real risk of forfeiture, and meet a number of other conditions (see paragraphs 1.155 to 1.162 for discussion of real risk of forfeiture). Alternatively, tax can be deferred on an ESS interest (that is a beneficial interest in a share or stapled security) acquired under salary sacrifice arrangements if the employee gets no more than $5,000 worth of shares under those arrangements in an income year. The employee share scheme rules for upfront taxation do not apply if an ESS interest qualifies for deferred taxation. ***[Schedule 1, item 1, subsection 83A-105(1)]***

1.141 When tax is deferred, the market value of the ESS interest *minus* the cost base of that interest is generally included in assessable income in the first income year it is possible to dispose of or exercise that interest. If employment ceases earlier, or if seven years pass, the relevant amount is included in that income year instead (see paragraphs 1.189 to 1.202 for the 'ESS deferred taxing point').

1.142 Consistent with the rest of the employee share scheme rules, the deferral rules also do not apply to a share acquired by exercising a right that has already been taxed under the employee share scheme rules, as outlined in paragraph 1.104. ***[Schedule 1, item 1, subsection 83A-20(2) and paragraph 83A-105(1)(a)]***

1.143 For deferred taxation to apply, the scheme which the ESS interest is acquired under must also meet a number of further conditions (see paragraphs 1.137 to 1.188 for a more detailed explanation).

Amount to be included in assessable income

1.144 Under deferred tax arrangements, the market value of the ESS interest at the deferred taxing point *reduced* by the cost base of the ESS interest is included in assessable income for the income year in which the deferred taxation point occurs. ***[Schedule 1, item 1, subsection 83A-110(1)]***

1.145 The market value substitution rule located in section 112-20 of the ITAA 1997 is ignored for the purpose of calculating the cost base of the asset and the amount to be included in assessable income. The market value substitution rule located in section 116-30 of the ITAA 1997, which generally applies to assets received for no capital proceeds, is also turned off. ***[Schedule 1, item 40, subsection 130-80(4)]***

1.146 If these rules were not ignored the value of the discount to the employee would not be correctly taxed.

1.147 Consistent with the treatment of most other types of income, whether an amount is included in a taxpayer's assessable income under the new ESS rules will depend on the taxpayer's residency status and the source of the income (see paragraphs 1.347 to 1.366). ***[Schedule 1, item 1, subsection 83A-110(2)]***

Calculating the value of shares at the taxing point

Market value

1.148 By default, the ordinary meaning of 'market value' is used for determining the value of ESS interests. The expression market value is often used with its ordinary meaning, however, in some cases it has a meaning affected by Subdivision 960-S of the ITAA 1997. An alternative method of valuation can be specified in the Regulations.
Paragraphs 1.106 to 1.113 provide further discussion on market value and valuation methodologies.

Cost base

1.149 The current employee share scheme rules calculate the discount on an ESS interest as market value less consideration paid or given.

1.150 Consideration paid or given does not take into account expenses such as interest and brokerage fees, or events such as value shifting, a return of capital or other expenses incurred in holding the asset that would alter the cost base.

1.151 The new law instead uses the tax concept of cost base, which takes into account a more comprehensive set of expenses and events. Cost base is a more appropriate base on which to calculate the discount and gains on the ESS interest up to the taxing point.

Example 1.5: Calculating the cost base

Joan acquires ESS interests in his employer, Raceway Co through an employee share scheme. She purchases the ESS interests for $1,000, at a 50 per cent discount to their market value of $2,000, and Raceway Co passes on brokerage fees of $50 to Joan.

The cost base of Joan's ESS interests is $1,050.

Example 1.6: Modifying the cost base

John acquires ESS interests in his employer, Jawbreaker Co through an employee share scheme. The ESS interests have a market value of $1,000. Jawbreaker's scheme meets the conditions for deferred taxation.

John pays $100 for the interests, and has a cost base of $100.

Six months after acquiring the interests, Jawbreaker Co returns 30 per cent of its capital to its shareholders, and John receives $300.

This return of capital will reduce John's cost base to nil. The remaining $200 will be assessed as a capital gain in the income year that it is received.

ESS interests at real risk of forfeiture

1.152 In situations where there is a real risk that the benefits of shares or rights are never realised because the ESS interests may be forfeited, deferral of taxation is considered the appropriate treatment.

1.153 Providing for the deferral of tax in these situations recognises that the employee may never have a chance to recognise the economic value of the ESS interest, and that having employee remuneration 'at risk'

in this manner is consistent with the purpose of concessionally taxing employee share schemes, namely to align the interests of employees and employers.

1.154 If an ESS interest is at real risk of forfeiture, and the scheme meets the other conditions outlined in the rules, taxation will be deferred until the ESS deferred taxing point (see paragraphs 1.189 to 1.202 for discussion of the ESS deferred taxing point).

The real risk of forfeiture test

1.155 To defer tax under the real risk of forfeiture test:

- in the case of a share, there must be a real risk under the conditions of the scheme that the employee will forfeit the share, or lose it other than by disposing of it; or
- in the case of a right to acquire a beneficial interest in a share:
  - there must be a real risk that, under the conditions of the scheme, the employee will forfeit the right, lose it other than by disposing of it, exercising it or letting it lapse; or
  - there must be a real risk that, under the conditions of the scheme, if the employee exercises the right to get a beneficial interest in a share, they will forfeit the beneficial interest in the share, or lose it other than by disposing of it.

[Schedule 1, item 1, subsection 83A-105(3)]

1.156 The ‘real risk of forfeiture’ test does not require employers to provide schemes in which their employee share scheme benefits are at a significant or substantial risk of being lost. However, ‘real’ is regarded as something more than a mere possibility. Something is not a real risk if a reasonable person would disregard the risk as highly unlikely to occur or as nothing more than a rare eventuality or possibility.

1.157 Forfeiture of an ESS interest may occur through a legal compulsion to transfer the ownership of an ESS interest back to the entity from which it was acquired, for example the return of the ESS interest to an employee share trust.

Example 1.7: Compulsory transfers of an ESS interest may be forfeiture

Byron enters into an employee share scheme arrangement with his employer, EightBall Co. Byron acquires legal ownership of 100 EightBall Co shares under an employee share scheme, but will be legally compelled to transfer these shares to a pooled employee share trust if in one year he has not met certain sales targets.

Real risk of forfeiture: Yes, Byron's shares are at real risk. If he meets the other conditions for deferral, he will defer tax until the 'ESS deferred taxing point'.

1.158 The 'real risk of forfeiture' test is intended to provide for deferral of tax when there is a real alignment of interests between the employee and employer, through the employee's benefits being at risk. The test is a principle based test, intended to deny deferral of tax where schemes contrive to present a nominal risk of forfeiture, without complying with the intent of the proposed law.

Example 1.8: Contrived risks

'Your shares are forfeited if the company's value falls by 95 per cent during the next 12 months' or 'your shares are forfeited if you request they be forfeited' are not real risks.

1.159 Real risk includes situations in which a share or right is subject to meaningful performance hurdles or the securities will be forfeited if a minimum term of employment is not completed.

1.160 A condition that merely restricts an employee from disposing of a share or right for a specified time carries with it no real risk of forfeiture.

Example 1.9: Forfeiture on cessation of employment

Ulrick enters an employee share scheme arrangement with his employer, Retrorocket Ltd. He will receive 1,000 Retrorocket shares in 12 months, if he is still employed by Retrorocket at that time.

Real risk of forfeiture: Yes, Ulrick's rights to receive shares are at risk because he will forfeit them if he leaves the company. If he meets the other conditions for deferral, he will defer tax until the 'ESS deferred taxing point'.

Example 1.10: Forfeiture on cessation of employment — a good leaver who leaves for reasons beyond their control

Jeanette enters into an employee share scheme arrangement with her employer, Zither Co. She will receive 1,000 Zither Co shares in three years, if she is still employed by Zither Co at that time.

Further, Zither Co will grant her shares to her if she ceases employment before three years for a reason beyond her control, such as sickness, invalidity, being made redundant, or Zither Co being sold or liquidated, under a 'good leaver clause'.

Real risk of forfeiture: Yes, Jeanette's rights to receive shares are at risk and she will defer tax for three years. However, if employees at Zither Co routinely received their shares regardless of their reason for leaving, the ATO may consider that the scheme has contrived a 'real risk' and is not eligible for deferral of tax.

Example 1.11: Forfeiture on cessation of employment — retirement

Gary enters into an employee share scheme arrangement with his employer, Jackhammer Co. He will receive 7,000 Jackhammer shares in three years time, unless he ceases employment before that time, except if he ceases employment to retire.

To meet the retirement condition, the scheme requires Gary to be above a certain retirement age, and to be leaving the work force. Gary is within six months of retirement.

Real risk of forfeiture: No, Gary does not have a real risk of losing his shares. This is because at the time of acquisition Gary knows that the good leaver provision will protect him from any real risk of losing the shares.

Example 1.12: Minimal risk contrived to gain deferral

Cucumber Co has opened an employee share scheme where the shares are subject to forfeiture in the first three months if the employee leaves the company. The shares cannot be sold in the first five years.

Real risk of forfeiture: No. This scheme appears to have contrived a real risk of forfeiture over a very short period of time, in order to gain access to a relatively long period of deferral. This is not a real risk, and the shares will be subject to upfront taxation.

Example 1.13: Fraud or gross misconduct

Joe enters into an employee share scheme arrangement with his employer, Gusto Co. He receives 1,000 Gusto shares, but will forfeit them if he is dismissed for fraud or gross misconduct in the next three years.

Real risk of forfeiture: No, Joe's shares are not at any real risk. A reasonable person would not consider there to be a real risk of forfeiture in relation to the scheme. Joe's decision to commit fraud or misconduct is entirely within his own control.

Example 1.14: Performance hurdles — market share

Amy enters into an employee share scheme arrangement with her employer, Crackerjack Co. She will receive 1,000 Crackerjack Co shares in one year, if Crackerjack Co's market share has increased by 10 per cent in 12 months time.

Crackerjack Co's market share was steady over the previous 12 months.

Real risk of forfeiture: Whether or not a real risk of forfeiture is present is a question of fact and circumstance.

In this case, the circumstances indicate a real risk that Amy's rights to receive shares could be forfeited. She will defer tax for the year.

Example 1.15: Performance hurdles — market price increasing

Jacob enters into an employee share scheme arrangement with his employer, Snowsuit Co. He receives rights to 1,000 Snowsuit Co shares in one year's time, if Snowsuit Co's share price has increased 10 per cent in 24 months time.

Snowsuit Co's share price has performed broadly in line with the sector index over the past five years, but has outperformed the consumer price index by an average 2 per cent.

Real risk of forfeiture: Whether or not a real risk of forfeiture is present is a question of fact and circumstance.

In this case, there is a real risk that Snowsuit Co's share price would not increase by 10 per cent. Jacob's right to receive to the shares is at risk and he will defer tax until the 'ESS deferred taxing point'.

Example 1.16: Performance hurdles — market price maintained

Sarah enters into an employee share scheme arrangement with her employer, Pepper Co. She receives rights to receive 1,000 Pepper shares in one year, if Pepper's share price has maintained its value in 24 months time.

The value of Pepper's share price has fallen 50 per cent in the last 12 months, and the company is facing financial hardship.

Real risk of forfeiture: Whether or not a real risk of forfeiture is present is a question of fact and circumstance.

In this case, there is a real risk that Pepper's share price will fall further in the next 24 months. Sarah will defer tax until the 'ESS deferred taxing point'.

Example 1.17: Performance hurdles — market price maintained

Nina enters into an employee share scheme arrangement with her employer, Salt Co. She receives rights to receive 1,000 Salt shares in one year, if Salt's share price has maintained its value in 24 months time.

The value of Salt's share price has risen by over 20 per cent each year for the past six years. Salt is forecasting continuing good performance.

Real risk of forfeiture: Whether or not a real risk of forfeiture is present is a question of fact and circumstance.

In this case, a reasonable person would not consider that Nina has a real risk of forfeiting her shares, given Salt's previous and continuing good performance and the relatively low performance hurdle Salt's share price is required to overcome.

Example 1.18: Performance hurdles over a portion of ESS interests

Pat enters into an employee share scheme arrangement with his employer, Maraca Co. He will receive 1,000 Maraca Co shares in one year if Maraca Co's market share increases over the year, and 500 Maraca Co shares in one year if it does not. There are no restrictions placed on latter 500 shares, and Pat will receive them regardless of whether he is still employed with Maraca Co in one year.

Real risk of forfeiture: Yes, but only in respect of 500 shares. Five hundred of Pat's rights to shares are at risk and he will defer tax on these for the year. However, Pat's other 500 rights to shares are not at risk, and he will pay tax upfront on the entitlement to these shares.

Example 1.19: Employee controlled risk

Maria works for Mustard Ltd, and is granted options which require her to regularly save a certain amount of post-tax money in an approved bank account to enable exercise of the options. The plan rules provide that, if the employee stops the regular savings, all of the options lapse.

There are no other conditions of the scheme that would result in Maria forfeiting the options.

Real risk of forfeiture: No. Maria will not be able to defer tax on the options. The decision to deposit a certain amount of money in a bank account is entirely within Maria's control and there is no real risk in the scheme.

Example 1.20: Employee controlled risk — prohibition on sale of original shares

Olivia works for Dressmakers Ltd, and she purchases some Dressmakers Ltd shares with her post-tax money and is granted, at that time, a matching right to an equivalent number of free shares in two years time if she does not sell the original shares over that two-year period. If she sells the original shares before two years have elapsed, the matching rights will lapse.

There are no other conditions of the scheme that would result in Olivia forfeiting the options.

Real risk of forfeiture: No. There is no real risk that Olivia will not be able to simply retain a number of shares over which she has legal ownership and no risk of forfeiture, so Olivia will not be able to defer taxation of the rights. The issue is that the decision to hold or not hold the shares is entirely within Olivia's control.

1.161 Whether a condition by which ESS interests were forfeited only if the employee left employment to join a competitor is sufficient to constitute real risk of forfeiture will depend on the circumstances of the individual case. In cases where it appears unlikely that an individual could take a comparably skilled job without forfeiting the ESS interest, such a restriction will likely be sufficient.

1.162 A condition that ESS interests will be forfeited if the employee leaves to work for any other employer will constitute a real risk of forfeiture in most circumstances.

Example 1.21: ESS interests likely to be forfeited if employee ceases employment

> Saskia is a doctor employed by a hospital with 10 years experience. Saskia receives shares through the hospital's employee share scheme, but will forfeit the shares if she leaves the hospital to work in the medical industry in Australia within the next five years.
>
> *Real risk of forfeiture:* Yes. Saskia is a highly skilled employee who would likely find it difficult to find a comparably skilled job outside the medical industry. Her shares are at real risk of forfeiture.

Scheme must relate to ordinary shares

1.163 The shares or rights offered under the scheme must relate to ordinary shares. ***[Schedule 1, item 1, paragraphs 83A-105(1)(b) and (c) and subsection 83A-35(4)]***

1.164 Deferred taxation is restricted to interests over ordinary shares to encourage the alignment of employee and employer interests. ESS interests that are not ordinary shares, such as preference shares, may have less 'risk' associated with them because they pay a more stable income stream and have priority over ordinary shares if the company winds up. They are therefore less likely to align the shareholder's interest with that of the company.

Schemes must be broadly available (in respect of shares)

1.165 The employer must offer a scheme or schemes that are available to at least 75 per cent of the Australian resident permanent employees of the company with three or more years service (whether continuous or non-continuous). This means over all the schemes that the employer offers, more than 75 per cent of Australian resident permanent employees with three or more years service must be able to access shares under at least one of those schemes. ***[Schedule 1, item 1, subsection 83A-105(2)]***

1.166 Consistent with the current law, this requirement does not apply to schemes that offer only rights to acquire a share, rather than shares.

1.167 While this requirement is to encourage schemes to be available as widely as possible, the scheme or group of schemes offered by an employer are only required to be offered to *permanent* employees with at least three years service, and only to 75 per cent of those employees, because it may be difficult in practice to offer the scheme to all employees including, for example, to casual employees.

1.168 The scheme is only required to be offered to 75 per cent of *Australian resident* permanent employees to ensure employers with a significant percentage of foreign employees can offer employee share schemes to their Australian employees without undue complexity.

Employee must not have significant ownership or voting rights

1.169 The interest provided to an employee must not result in the employee having effective ownership of greater than 5 per cent of their employer, and not controlling more than 5 per cent of the maximum voting rights in the employer. ***[Schedule 1, item 1, paragraphs 83A-105(1)(b) and (c) and subsection 83A-35(9)]***

1.170 This provision encourages the benefits of the employee share scheme to be spread widely among employees. The concession is intended to encourage employees with small or no ownership in their employer to take up an interest in the company. It is considered that if one employee owns more than 5 per cent of the voting rights, interests between the company and that shareholder are already aligned, and no tax concession is appropriate.

1.171 Further, this also acts as an integrity rule that prevents taxpayers from misapplying the concession in order to buy a business or indirectly access company profits through the employee share scheme rules. The concession is intended to apply in respect of the employee/employer relationship and not in relation to the company/shareholder relationship.

1.172 The 5 per cent rule is administered on an employee by employee basis. That is, any individual employee breaching the 5 per cent rule will make that employee ineligible for deferred taxation, but have no impact on other employees participating in the scheme.

ESS interests provided through a salary sacrifice scheme

1.173 The deferral arrangements also allow for shares received at a discount through a salary sacrifice arrangement to be subject to deferred taxing treatment, if the salary sacrifice arrangement is part of the employee’s remuneration package, and it is reasonable to conclude in the circumstances that the salary or wages would be greater if the shares was not a part of that package. The risk of forfeiture is not necessary to get deferred taxation treatment through a salary sacrifice scheme.

1.174 Providing for deferred tax in the case of employee share schemes involving salary sacrifice arrangements ensures that certain employees utilising similar arrangements under the existing law will continue to be able to access these arrangements with minimal disruption. This encourages the broad availability of, and participation in, employee

share schemes, and the broad alignment of the interests of employees and employers in Australia.

ESS interest must be acquired solely under salary sacrifice arrangements

1.175 For tax to be deferred under the ‘salary sacrifice case’, the ESS interest must be provided:

- because the employee agreed to acquire the interest in return for a reduction in salary or wages that would not have happened apart from the agreement; or
- as part of the remuneration package, in circumstances where it is reasonable to conclude that the employee’s salary or wages would be greater if the interest was not part of that package.

[Schedule 1, item 1, paragraph 83A-105(4)(a)]

1.176 This is in line with the current salary sacrifice definition in the FBTAA 1986.

1.177 In order for deferred tax treatment to apply the employee must receive the shares for no consideration. That is, the discount per share provided through the arrangement must be equal to the market value of the share. ***[Schedule 1, item 1, subparagraph 83A-105(4)(b)(i)]***

1.178 The ESS interests over which tax is deferred under the salary sacrifice arrangements must be beneficial interests in shares and not rights. Other ESS interests provided under the scheme, which are eligible for deferred taxation because they are at real risk of forfeiture, may be beneficial interests in either shares or rights. ***[Schedule 1, item 1, subparagraph 83A-105(4)(b)(ii)]***

1.179 This ensures the employers have the flexibility to provide schemes with both ESS interests acquired under salary sacrifice arrangements, and ESS interests at real risk of forfeiture. For example, an employer may provide a ‘matching scheme’, where the employee salary sacrifices remuneration in return for a number of shares, and the employer offers rights to a matching number of shares to be provided at a later time, subject to certain forfeiture conditions being met.

Governing rules of the scheme must state that deferred taxation applies to the scheme

1.180 For tax to be deferred under the 'salary sacrifice case', the governing rules of the scheme must expressly state that the deferred taxation arrangement applies to the taxation of the scheme. ***[Schedule 1, item 1, subparagraph 83A-105(4)(b)(iii)]***

1.181 This requirement is to clearly differentiate the scheme from similar salary sacrifice schemes where the intent is not to be subject to the deferred taxation arrangements.

1.182 A statement in the document offering an employee the opportunity to participate in the employee share scheme would be sufficient to fulfil this requirement.

Example 1.22: Example of a sentence that could be included in the offer document

> 'This scheme is a scheme to which Subdivision 83A-C of the *Income Tax Assessment Act 1997* applies (subject to the conditions in that Act).'

Example 1.23: Matching schemes

> Fiona is an employee of Reading Co. For every share that Fiona purchases under Reading Co's employee share scheme using salary sacrifice arrangements, Reading Co provides Fiona with the right to an additional 'matching' share in two years time, provided that Fiona is still employed by Reading Co at that time.
>
> Fiona sacrifices $1,000 salary for 100 shares with a market value of $1,000. If she remains employed with the Reading Co for two years, she will receive an additional 100 shares at that time.
>
> The governing rules of the scheme must expressly state that the deferred taxation arrangement applies to the taxation of the scheme.
>
> This matching scheme will be eligible for deferral. Fiona's 100 shares are eligible for deferral because they are provided under eligible salary sacrifice arrangements, and her 100 'matching' rights are eligible for deferral of tax under the real risk of forfeiture arrangements.
>
> Fiona will defer tax on her 100 shares and 100 rights until the 'ESS deferred taxing point' arises. The 'ESS deferred taxing point' may differ for the 100 shares, and the 100 matching rights.

ESS interests acquired must not exceed $5,000 per annum

1.183 The total market value of the shares acquired during an income tax year under a salary sacrifice arrangement must not exceed $5,000, based on the market value of each interest at the time the interest is acquired, for a scheme to be eligible for deferred taxation. ***[Schedule 1, item 1, paragraph 83A-105(4)(c) and subsection 83A-105(5)]***

1.184 The $5,000 limit is allowed per employee per employment relationship. However, employees with more than one employment relationship within a particular corporate group cannot access the $5,000 cap twice.

1.185 The $5,000 limit over shares acquired under salary sacrifice arrangements does not preclude ESS interests of greater value that are eligible for deferral of tax under the real risk of forfeiture arrangements being provided under the same scheme.

Example 1.24: $5,000 per employment relationship

> During the same tax year, Allan worked in three shops — Brick Co, Cement Co and Nursing Co. Brick Co and Cement Co are part of the same corporate group, as they belong to the same holding company. Allan would be able access deferred tax treatment for any shares he acquired through a salary sacrifice arrangement as part of his remuneration package for $5,000 combined between shops Brick Co and Cement Co, and a further $5,000 worth from Nursing Co, as it is unrelated to the holding company for shops Brick Co and Cement Co.

1.186 This requirement ensures that deferral of tax under the salary sacrifice arrangements is limited, providing a relatively more attractive concession for low and middle income earners.

1.187 The scheme must also relate to ordinary shares, be part of a broadly available set of schemes, and no employee must receive ownership rights greater than 5 per cent, as explained in paragraphs 1.163 to 1.172. ***[Schedule 1, item 1, paragraphs 83A-105(1)(b) and (c)]***

1.188 Tax which is deferred over ESS interests acquired through salary sacrifice arrangements will be payable at the ESS deferred taxing point.

The ESS deferred taxing point

1.189 When tax on an employee share scheme discount is deferred under either the salary sacrifice or real risk of forfeiture arrangements, it is deferred until the ESS deferred taxing point occurs.

ESS deferred taxing point for shares

1.190 The deferred taxing point for shares is the earliest of the following possible taxing points:

- there is no real risk that the employee will forfeit the share, or lose it other than by disposing of it, and there are no genuine restrictions preventing its disposal; or
- when the employee ceases the employment in respect of which they acquired the share; or
- seven years after the employee acquired the share.

[Schedule 1, item 1, subsections 83A-115(1), (2 and (4) to (6)]

1.191 The deferral period is limited by the ESS deferred taxing points to ensure fairness, continue to align the interests of the employer and employee, and preserve the integrity of the tax system by preventing unlimited deferral of tax on employment remuneration.

1.192 Genuine restrictions preventing disposal could include a condition of the scheme that contractually prevents disposal of shares. If disposing of an ESS interest would be a criminal offence, for example under a law regulating insider trading, then the employee would also be considered genuinely restricted from disposing of the share.

1.193 A company's internal share trading policy is only considered to be a restriction preventing disposal for the purposes of deferring the taxing point if the penalty for breaking the policy constitutes an effective sanction. This means that if there is no legal prohibition on the disposal of the ESS interest, there must be serious and enforced consequences for breaching the policy.

1.194 A restriction that otherwise meets the conditions for a genuine restriction, but is able to be lifted in cases of severe financial hardship, is nonetheless considered to be a genuine restriction.

1.195 Restrictions preventing disposal are considered to be lifted once an opportunity arises in which a taxpayer can realise the share.

1.196 In the case of a trading window, or restrictions that may lift and then re-engage, if the employee does not avail themself of the opportunity to dispose of the share and the window subsequently closes, there is no further delay in the taxing point. The taxing point would still be at the commencement of the first trading window.

Example 1.25: Genuinely restricted

Under an employee share scheme run by Oranges Co, Jack receives 5,000 shares which are subject to forfeiture in the event that he leaves employment before five years from time he acquired the shares. If Jack remains employed for two years, a pro-rata portion of the shares will no longer be subject to forfeiture (3,000 vested after three years, 4,000 vested after four years etc) *but* Jack is prohibited from selling any of the shares until year five, unless he leaves employment between years two and five. If Jack leaves between these times, a portion of the shares will be available for sale, and a portion will be forfeited.

After two years, Jack is still considered to be genuinely restricted from selling the shares and continues to defer tax until the earliest of year five, or when he ceases employment.

If at the end of year three Jack leaves Oranges Co, he will be taxed on 3,000 shares at this point, and forfeit 2,000 shares.

If Jack remains employed by Oranges Co for six years, the taxing point will arise for all the shares at the end of year five, when the restrictions on selling the shares lift.

Example 1.26: Genuinely restricted

Angie is employed by Lime Co, and receives shares in Lime Co through their employee share scheme. Lime Co has a policy that employees cannot trade Lime shares for three weeks prior to Lime Co’s annual and half-yearly financial reports being released.

Lime Co does not enforce this policy.

Angie is not under a genuine restriction as a result of the policy, and will disregard the policy in determining her deferred taxing point.

Example 1.27: Genuinely restricted

Marceli is employed by Housecoat Co, and receives shares in Housecoat Co through their employee share scheme. Housecoat Co has a policy that employees cannot trade Housecoat shares for three weeks prior to Housecoat Co’s annual and half-yearly financial reports being released. The policy makes clear that employees found in breach of the policy will have their employment terminated.

Housecoat Co strictly enforces this policy.

Marceli is under a genuine restriction as a result of the policy.

Example 1.28: Not genuinely restricted

Evelyn is employed by Sprocket Co, and receives shares in Sprocket Co through their employee share scheme. No Sprocket employee may trade in Sprocket shares without first seeking the permission of a manager.

Evelyn is not under a genuine restriction. A genuine restriction should not be open to manipulation.

Example 1.29: Genuinely restricted

Jacqueline is employed by Turboprop Co and receives shares in Turboprop Co through their employee share scheme.

Jacqueline will forfeit her shares if she ceases employment with Turboprop in the next two years, and so is under a real risk of forfeiture.

When entering into the scheme, Turboprop offers Jacqueline a choice to be restricted from selling her shares for a three, four or five-year period. She must choose when she enters the scheme, and her choice will be final.

If Jacqueline chooses the four-year restriction, her deferred taxing point will occur in four years, or at cessation of employment.

1.197 The restriction and conditions covered by the deferred taxing points are only those that existed when the employee acquired the ESS interest. Conditions and restrictions that have been added subsequent to acquisition are ignored for the purposes for determining the deferred taxing point.

ESS deferred taxing point for rights

1.198 The deferred taxing point for rights is the earliest of the following times:

- when the employee ceases the employment in respect of which they acquired the right;
- seven years after the employee acquired the right;
- when there are no longer any genuine restrictions on the disposal of right (for example, being sold), and there is no real risk of the employee forfeiting the right; or

- when there are no longer any genuine restrictions on the exercise of the right, or resulting share being disposed of (such as by sale), and there is no real risk of the employee forfeiting the right or underlying share.

[Schedule 1, item 1, subsections 83A-120(1), (2) and (4) to (7)]

Example 1.30: Deferred taxing point

Adrian works for Pear Co, and is granted options to acquire ordinary shares in Pear Co on the payment of an exercise price. The options will be forfeited if Adrian ceases employment with Pear Co within two years from the time of acquisition, which constitutes a real risk of forfeiture. The earliest time the options are able to be exercised is two years from grant. The options cannot be sold or disposed of, and if the options are exercised, the resulting shares cannot be sold or disposed of for five years from the time of acquisition of the options.

Three years later Adrian is still in employment with Pear Co, exercises his options and acquires shares. At this point, the scheme still restricts Adrian from disposing of the shares, and he continues to defer tax.

At five years from grant Adrian is still employed by Pear Co, and the restrictions on sale of the shares lift. This will be Adrian's deferred taxing point.

Example 1.31: Options which have not had an ESS deferred taxing point before the lapse

Jessica works for Lemon Co, and is granted non-transferable options to acquire ordinary shares in Lemon Co on the payment of an exercise price. The options will be forfeited if Jessica ceases employment with Lemon Co within three years from grant, which constitutes a real risk of forfeiture. The earliest time the options are able to be exercised is three years from grant. However, the options are not exercisable unless the Lemon Co share price is at least equal to the exercise price of the options. The exercise price is equal to the market value of the Lemon Co shares at the time of grant of the options. The options will lapse six years from grant.

Jessica's ESS interests are at real risk of forfeiture, and the shares meet the conditions of deferred taxation. Tax would not be payable upfront as the employee would be subject to a real risk of forfeiting the options. The options are not exercisable until at year three or some time thereafter the Lemon Co share price is at least equal to the exercise price.

Assume that the employee is still employed with Lemon Co seven years from grant of the options, but that the options all lapse at year six because the Lemon Co share price remains below the exercise price at

all times between year three and year six (and therefore the options have never been exercisable).

As an ESS deferred taxing point has not arisen when the rights lapse at year six, there would be no amount included in assessable income under the employee share scheme rules, and no tax on the lapsed right would be payable.

Example 1.32: Multiple restrictions on sale

Jay works for Strawberry Co, and is granted non-transferable options to acquire ordinary shares in Strawberry Co on the payment of an exercise price on 1 July 2010.

The options will be forfeited if Jay leaves employment with Strawberry Co within two years from grant, prior to 1 July 2012. As such, Jay's options are at real risk of forfeiture and he will defer tax until the ESS deferred taxing point.

The earliest time the options are able to be exercised is 1 July 2012, and the options can be exercised only if both of the following conditions are also met at that time:

- Jay is in the top 50 per cent of Strawberry Co salespeople (based on sales volume) over the previous financial year; and
- Strawberry Co's share price is at least equal to the exercise price of the options.

Jay is consistently in the top 50 per cent of Strawberry Co's salespeople. The market price of Strawberry Co shares exceeds the strike price for the first time on 1 September 2015.

As at 1 September 2015 both conditions are met (for the first time concurrently), this is Jay's deferred taxing point. The taxing point will occur regardless of whether or not Jay chooses to exercise.

1.199 The current rules for the taxing point for rights are subject to additional concessionality (by way of a longer deferral period) and are therefore open to greater abuse from those wishing to artificially defer the taxing point. Bringing the taxing points for rights into closer alignment with those for shares will ensure that taxpayers cannot seek to undermine the integrity changes proposed to the refund rules.

1.200 The taxing point is the point at which the taxpayer can take some action to realise the benefit. It does not matter whether or not they chose to do so.

30-day rule for the ESS deferred taxing point

1.201 The ESS deferred taxing point for the ESS interest (an interest in either a share or a right) is moved to the time the employee disposes of the interest if they dispose of the interest within 30 days of the original deferred taxing point. ***[Schedule 1, item 1, subsections 83A-115(3) and 83A-120(3)]***

1.202 This will make compliance easier by avoiding unnecessary valuation and the application of multiple taxing regimes within short periods of time.

Employee share schemes and capital gains tax

1.203 ESS interests are exempted from CGT events (in most cases) until the interest has been taxed under the employee share scheme rules. As the employee share scheme rules are intended to be the primary taxing regime for ESS interests during the period of deferred taxation, application of the CGT provisions would potentially result in double taxation. ***[Schedule 1, item 40, subsection 130-75]***

1.204 Once an ESS interest has been taxed under the employee share scheme rules, it is subsequently taxed consistent with other capital assets, most likely under the CGT regime, but possible under other regimes such as the trading stock rules.

1.205 Certain shares that are not ESS interests provided under an employee share scheme, but have been acquired by an employee share trust to satisfy the possible exercise of an ESS interest that is a right to a share, are also exempted from certain CGT events (see paragraphs 1.225 to 1.228).

1.206 Further, to ensure employees participating in employee share schemes are taxed consistently regardless whether or not the scheme utilises a trust structure, special provisions are included relating to employee share trusts.

Disregard most CGT events during the period of deferred taxation

1.207 The new law continues to exempt ESS interests from tax under the CGT provisions until the ESS interest has been taxed under the employee share scheme tax rules. An exception is made in the case of certain CGT events that primarily affect the cost base of the ESS interest, which apply throughout the life of the ESS interest. ***[Schedule 1, item 40, subsection 130-80(1)]***

1.208 Ensuring that these CGT events which affect the cost base of the ESS interest continue to operate, those involving a return of capital to the

employee or value shifting (CGT events E4, G1 and K8), results in a fair tax treatment. If these events did not operate to adjust the cost base of the ESS interest and the related share or right, capital gains returned to the employee as capital payments would not be taxed.

CGT treatment of an ESS interest after taxing point

1.209 Once an ESS interest has been taxed under the employee share scheme rules, it is subsequently taxed consistent with other capital assets, most likely under the CGT regime, but possible under other regimes such as the trading stock rules.

1.210 To ensure that CGT applies fairly and double taxation is avoided, the employee share scheme rules consider ESS interests to be (re)acquired for their market value immediately after the point they are taxed under the employee share scheme rules.

1.211 That is, for ESS interests that are taxed upfront, the interest (and the share or right of which it forms part) is taken to have been acquired for its market value from the point at which the taxpayer initially acquired the ESS interest ***[Schedule 1, item 1, section 83A-30]***. For ESS interests over which tax is deferred, the ESS interest (and the share or right of which it forms part) is taken to have been reacquired immediately after the ESS deferred taxing point ***[Schedule 1, item 1, section 83A-125]***. This resets the cost base of the ESS interest to market value, and resets the acquisition time, which may be relevant to an employee's eligibility for the CGT discount.

1.212 Once an ESS interest has been taxed under the employee share scheme rules, and the interest is taken to have been (re)acquired at its market value, it is most likely that the CGT regime will tax any subsequent gains.

Example 1.33: Upfront tax

> Robyn acquires ESS interests in her employer, Chessboard Co, for $300 under an employee share scheme. The interests have a market value of $600, so Robyn acquired the interests at a $300 discount. The scheme is subject to upfront taxation, and Robyn is not eligible for the upfront discount, so Robyn will include $300 in her assessable income under the employee share scheme rules.
>
> Robyn is taken to have acquired her ESS interests at market value for purposes other than the employee share scheme rules, and the cost base at that time is reset to $600 (at the time of upfront taxation which is also the time the asset is acquired).
>
> Any subsequent gains or losses will be recognised under the CGT regime.

Example 1.34: Deferred tax over shares

Annette acquires shares in her employer, Petal Co, for $200 under an employee share scheme. The shares have a market value of $300, so Annette acquired the shares at a $100 discount to their market value.

As the scheme Annette participates in meets the conditions for deferral of tax, she must defer until the ESS deferred taxing point occurs. While tax is deferred, any CGT events are disregarded (with the exception of certain events that may have an impact on the cost base).

Four years after she acquired the shares Annette ceases employment with her employer, triggering the deferred taxing point. The ESS interests now have a market value of $400. The employee share scheme tax rules require her to include the value of the discount and subsequent market gains (current market value *less* the cost base) in her assessable income ($200). This amount will be taxed at Annette's marginal tax rate.

At this point the shares are taken to have been reacquired. The shares will now have a cost base of $400.

Because the shares are taken to be reacquired, if Annette chose to dispose of them within 12 months of the ESS deferred taxing point occurring, she would not be able to apply the CGT discount.

However, in this example she chooses to sell the shares (originally acquired under the employee share scheme) two years after the ESS deferred taxing point has occurred, at the market value of $600. Annette will pay tax on the $600 *less* the cost base of $400 (a capital gain of $200). She will be able to apply the 50 per cent CGT discount, therefore including $100 in her assessable income (assuming she has no capital losses to apply).

If the shares' cost base had not been reset to their market value at the deferred taxation point, Annette would instead have had a capital gain of $400 and have faced double taxation on the first $200 of the gain.

Example 1.35: Deferred tax over rights

Tom acquires rights to shares in his employer, Nibbler Co, for $100. The rights have a market value of $400 under an employee share scheme, so Tom acquired the rights at a $300 discount to their market value. The ESS interests are rights to acquire shares in Tom's employer.

The scheme Tom participates in meets the conditions for deferral of tax, so he must defer tax until the ESS deferred taxing point occurs. While tax is deferred, any CGT events are disregarded (with the exception of certain events that primarily have an impact on the cost base).

Six months after he acquires the rights, they are no longer under any real risk of forfeiture, and Tom is under no genuine restriction which is preventing him from exercising the rights and disposing of the underlying shares. The market value at that time is $500. This triggers the ESS deferred taxing point. The employee share scheme tax rules require Tom to include the value of the discount and subsequent market gains (current market value less the cost base) in his assessable income ($400). This will be taxed at Tom's marginal tax rate.

At this point the ESS interest is taken to have been reacquired. The asset will now have a cost base of $500 (the market value when the ESS deferred taxing point occurred).

Because the asset is taken to be reacquired, if Tom chose to dispose of or exercise the rights within 12 months of the ESS deferred taxing point occurring, he would not be able to apply the CGT discount.

Nine months after the ESS deferred taxing point occurred, Tom exercises the rights, and acquires shares. This triggers a CGT event.

However, the general CGT rules which apply when options are exercised mean that:

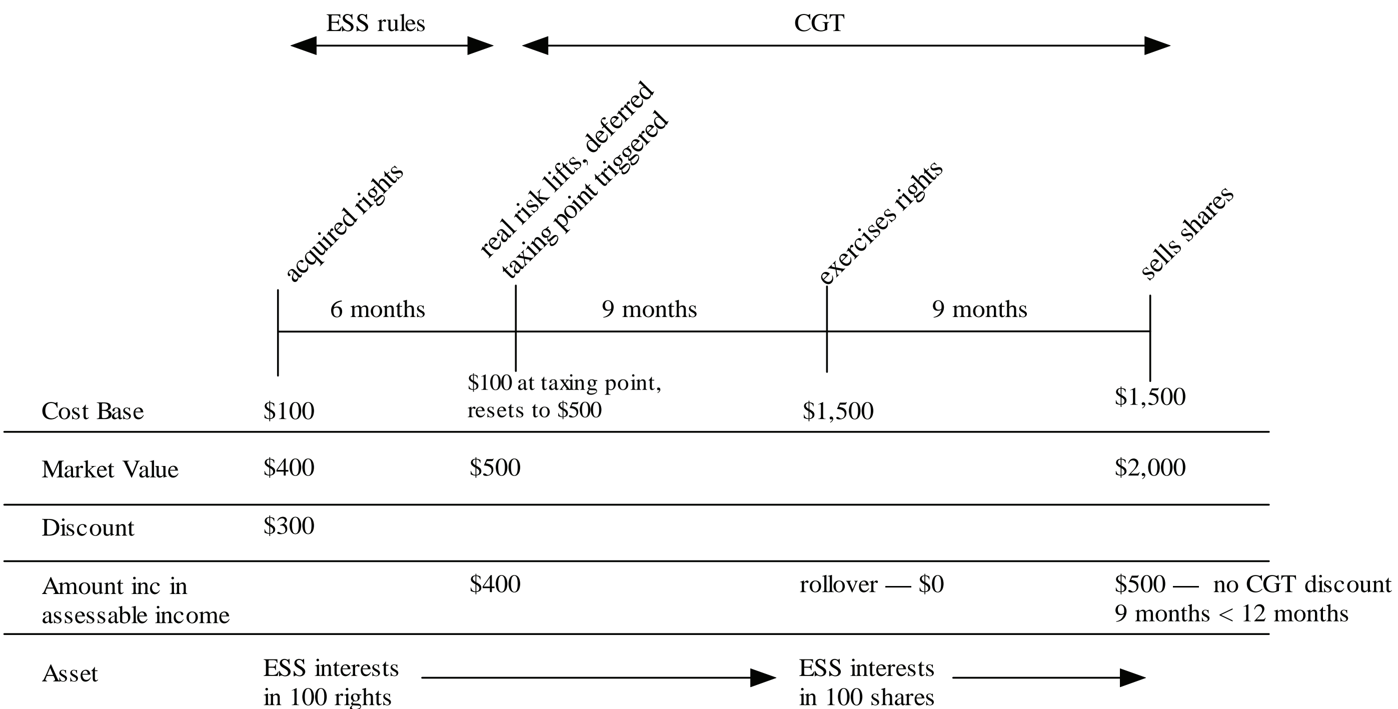
- any capital gain or loss made on the exercise of the options is disregarded;
- the cost base of the shares will be taken to be the cost base of the previous rights plus the strike price; and
- the CGT acquisition date will be reset, and Tom will not be able to apply the CGT discount in relation to the shares for a further 12 months.

(See the rollover provisions in Division 134 of the ITAA 1997)

In this example, the rights have a strike price of $1,000, so the shares will have a cost base of $1,500.

Nine months after Tom exercised the rights and acquired shares, he sells the shares at their market value of $2,000. Tom will pay tax on the $2,000 *less* the cost base of $1,500. Because it is less than 12 months since the previous CGT event (when he exercised the rights) Tom may not apply the CGT discount.

Diagram 1.1: Diagrammatic representation of Example 1.35



1.213 The employee share scheme rules and the CGT regime are based around different concepts. The employee share scheme rules tax ESS interests (beneficial interests in shares or rights), whilst the CGT regime refers to CGT assets and CGT events that are primarily based on ownership of the share or right itself.

1.214 The new law includes a specific provision to ensure that an appropriate link is established between the concepts used in each of the regimes. ***[Schedule 1, item 40, section 130-95]***

CGT and employee share trusts

1.215 The provisions relating to the CGT regime and trusts are restricted to employee share trusts (as opposed to other trusts) for reasons of integrity. Other trusts are more appropriately treated as associates of the employee.

1.216 An ***employee share trust*** is a trust which obtains employee share scheme interests in a company, and provides them on behalf of employers to employees of that company or their associates, or carries out activities incidental to the holding and providing of ESS interests (for example, bookkeeping, passing on dividends or opening and closing employee accounts). ***[Schedule 1, item 40, subsection 130-85(4)]***

1.217 The employee share scheme rules aim to tax employees participating in employee share schemes consistently, regardless of whether the employees immediately receive legal title to the ESS interests, or the scheme utilises a trust structure.

1.218 To achieve this, the new employee share scheme rules treat an employee who acquires an ESS interest through an employee share trust to be absolutely entitled to the share or right to which the ESS interest relates from the time that they acquire the ESS interest, if the employee share scheme rules apply to the interest. ***[Schedule 1, item 40, subsections 130-85(1) and (2)]***

1.219 This mechanism simplifies the taxation of employees who hold ESS interests in an employee share trust and ensures a consistent treatment of the cost base of the ESS interest with employees who hold legal title to the interest.

1.220 Under the CGT regime, if a beneficiary of a trust is absolutely entitled to an asset of the trust, the beneficiary is taxed in relation to any gain or loss relating to the interest (not the trustee). Some background to the meaning of ‘absolutely entitled’ is contained in draft taxation ruling TR 2004/D25.

1.221 Treating an employee as fully entitled to a share or right ensures that CGT applies only to the employee and not to the employee share trust from the point that the share or right is acquired under an employee share scheme. The effect of the provision is to ignore the existence of the employee share trust for CGT purposes.

1.222 By bringing forward the absolute entitlement to the relevant share or right, CGT event E5 (becoming fully entitled to a trust asset) is brought forward to the employee's acquisition time. The employee share trust will be taxed on any gains to date, and all subsequent tax liabilities under either the employee share scheme rules or the CGT regime will accrue to the employee.

1.223 Taxing the employee share trust at the time the employee acquires the ESS interest under the scheme is appropriate, as the trust may have been holding unallocated ESS interests for a period of time, and those capital gains will be taxed under the CGT regime consistent with the normal application of the CGT regime.

Example 1.36: CGT and employee share trusts

> Coolant Co operates an employee share scheme utilising an employee share trust. Coolant Co issues 100 Coolant Co shares with a market value of $500 into the employee share trust.
>
> Three months later Coolant Co provides its employee, Rebecca, with ESS interests in 100 Coolant Co shares in the employee share trust for no cost to Rebecca. The shares now have a market value of $550, and Rebecca is treated as being absolutely entitled to these shares. Rebecca's scheme is not eligible for deferred tax, and she will be taxed upfront, and she is not eligible for the upfront concession.
>
> Rebecca becoming absolutely entitled to the shares triggers CGT event E5, resulting in the trustee of the employee share trust being taxed on the $50 of accrued capital gain in the shares.
>
> Rebecca will include the value of the discount in her assessable income, that is, $550.
>
> Any further gains or losses on these shares will be recognised as belonging to Rebecca under the CGT regime (unless Rebecca forfeits the shares and is eligible for a refund of tax).

1.224 Treating the employee as absolutely entitled to the underlying share or right from the point that they acquire an ESS interest ensures that they will be taxed consistently with an employee who acquired legal title to the relevant share or right at the time they acquired the ESS interest.

Shares held to satisfy issued rights to shares

1.225 Capital gains or losses are disregarded for certain CGT events that occur in relation to shares acquired by an employee share trust to satisfy the future exercise a right to a share provided under an employee share scheme. The CGT events for which the gains or losses are disregarded are E5 — beneficiary becoming entitled to a trust asset, and E7 — disposal to a beneficiary to end capital interest. ***[Schedule 1, item 40, subsection 130-90(1)]***

1.226 Although the shares are acquired by the trust in relation to employee share schemes, they are not provided under an employee share scheme and so will not be subject to the employee share scheme rules. They are primarily subject to the CGT regime.

1.227 Capital gains or losses on these shares are disregarded in recognition that the gains are already embedded in the value of the right to the share (in which the employee has a beneficial interest that will be taxed under the employee share scheme rules). These provisions ensure that the gain will only be taxed once.

1.228 Consistent with the current law, the gains or losses will not be disregarded if the employee acquires the share for more than its cost base in the hands of the employee share trust. This is to ensure that there are no untaxed capital gains in the share which are not embedded (and taxed) in the value of the right to the share. ***[Schedule 1, item 40, subsection 130-90(2)]***

Example 1.37: Shares held to satisfy issued rights to shares

> Packsaddle Co operates an employee share scheme, and provides rights to Packsaddle shares to its employees which will become exercisable in two years time. Packsaddle Co's employee share trust acquires shares in anticipation of the possible exercise of these rights.
>
> In two years time, a number of these rights are exercised, and the employee share trust provides the shares to the employee. If this results in CGT event E5 or E7 occurring, any gains or losses on the shares are disregarded in the hands of the trustee (provided that the employee acquires the share for less than its cost base in the hands of the employee share trust).

CGT, employee share trusts and the refund provisions

1.229 An employee who acquires ESS interests under an employee share scheme through an employee share trust is deemed to be absolutely entitled to the interest by operation of the employee share scheme rules from the date of acquisition of the ESS interest.

1.230 If an employee is entitled to a refund of tax under the employee share scheme rules, the refund provisions undo any previous application of the employee share scheme rules. That is, the employee share scheme rules are taken never to have applied (see paragraphs 1.325 to 1.336).

1.231 If the employee share scheme rules never applied, the employee may not be absolutely entitled to ESS interests over which they were previously treated as having been absolutely entitled to (by operation of the provisions described in paragraphs 1.217 to 1.224).

1.232 Previous income tax assessments of the employee and the employee share trust may need to be amended to reflect this.

1.233 If an ESS interest is forfeited, the CGT integrity provision that substitutes market value when the disposal or cancellation of an asset results in no capital proceeds will not apply. ***[Schedule 1, item 40, subsection 130-80(4)]***

1.234 This provision would not be appropriate because there are legitimate circumstances in which an ESS interest may be forfeited, resulting in no capital proceeds.

1.235 The rule that instructs the taxpayer to disregard most CGT events in relation to an ESS interest until it has been taxed under the employee share scheme tax rules does not apply if those interests are forfeited. This ensures that an employee who pays money to acquire ESS interests will receive a capital loss in respect of this payment if they subsequently forfeit those ESS interests, or lose them other than by disposing of them. ***[Schedule 1, item 40, subsection 130-80(2)]***

1.236 The market value substitution rule is turned off when ESS interests are forfeited for the same reason. ***[Schedule 1, item 40, subsection 130-80(4)]***

CGT — Miscellaneous

1.237 The new employee share scheme rules continue to treat employee share scheme interests provided to associates of employees in relation to an employee's employment as though the interest was in fact acquired by the employee rather than the associate.

1.238 This provision also applies for the purposes of exempting the ESS interests from CGT events during the period of deferred taxation (with certain exceptions).

1.239 An employee will also be considered absolutely entitled to the relevant share or right if an associate of the employee acquires an ESS

interest, related to the employee's employment, through an employee share trust (see paragraphs 1.267 to 1.274 for further discussion of associates). ***[Schedule 1, item 40, paragraph 130-100(b)]***

1.240 After employee is taxed under the employee share scheme rules, the associate is considered absolutely entitled to the relevant ESS interests. The CGT regime will recognise any further gains or losses as belonging to the associate. In other words, the employee is no longer treated to have the ESS interests of the associate. ***[Schedule 1, item 40, subsection 130-85(3)]***

1.241 An employee may be treated as absolutely entitled to an interest in an employee share trust, even if that interest does not correspond to particular shares (see paragraphs 1.277 to 1.279). ***[Schedule 1, item 40, paragraph 130-100(c)]***

1.242 The employee share scheme rules relating to takeovers and restructures (see paragraphs 1.244 to 1.265), relationships similar to employment (see paragraphs 1.373 to 1.375), stapled securities (see paragraphs 1.377 to 1.382) and indeterminate rights (see paragraphs 1.367 to 1.372) are applicable to interests provided through an employee share trust. ***[Schedule 1, item 40, paragraphs 130-100(a) and (d) to (f)]***

1.243 The CGT acquisition rule that considers a taxpayer to have acquired a share or right from the time the contract is entered into, is turned off for shares or rights that an employee has an ESS interest in. This ensures that the acquisition dates under the CGT regime and the employee share scheme rules are aligned. ***[Schedule 1, item 40, subsection 130-80(3)]***

Takeovers and restructures

1.244 The employee share scheme rules ensure that employees are not adversely affected by takeovers and restructures, by allowing taxpayers who have deferred tax under an employee share scheme to roll-over an ESS deferred taxing point that would otherwise occur due to a corporate restructure.

1.245 Since there are situations where employees may defer their income tax liability arising from a discount on shares or rights, a corporate restructure may give rise to a deferred taxing point by triggering a disposal of the shares or rights or by breaking the employment relationship between an employee and the company that originally granted the shares or rights. This would not be the intended outcome.

1.246 The new rules ensure this is not the case by allowing the employee share scheme rules to still apply if an arrangement is entered

into that results in the original company becoming the subsidiary of another company, or if there is a change in the ownership of the existing company that results in any ESS interests in the old company being replaced, whole or partly, by ESS interests in one or more other companies. ***[Schedule 1, item 1, subsection 83A-130(1)]***

1.247 The roll-over relief will not apply to deferred taxing points that occur outside of corporate restructures.

1.248 A taxing point will still arise when an employee's employment ceases with the employer, when the disposal restrictions expire, or the seven year maximum deferral period occurs, whichever event happens first.

1.249 The provision of roll-over relief for corporate takeovers and restructures was explained in detail in the explanatory memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004. There have been no policy changes to the operation of those rules.

Treat new interests as continuations of old interests

1.250 The interests in the new company that are acquired in connection with the takeover or restructure are treated as a continuation of the original ESS interests. This only applies to the extent that as a result of the arrangement or change, the employee stops holding the old interests and the new interests can reasonably be regarded as matching any of the old interests. The new interests must be ordinary shares or rights over ordinary shares. ***[Schedule 1, item 1, subsections 83A-130(2) and (4)]***

1.251 Matching shares or rights are the replacement shares or rights provided to put the employee in the same position financially after the corporate restructure as before it. Matching shares or rights should be no more than that which is required to place the employee in the same position financially as if the restructure had not occurred.

1.252 The relief is limited to matching shares so that the taxpayer does not receive any additional benefit as a result of the restructure than he or she would otherwise have received.

1.253 It must be possible to identify the shares or rights that the employee holds as a result of the restructure and they must reasonably match the employee's original holding of shares or rights immediately before the restructure.

1.254 While the taxpayer should not receive any additional benefit, there need not be a one-to-one ratio between the old and the new shares or

rights in order for them to be matching, provided that the value of the new shares or rights relative to the old shares or rights remains unchanged.

1.255 To be regarded as reasonably matching, the attributes of the shares or rights immediately before the restructure need to be the same, or substantially the same, immediately after the restructure. Attributes include whether it is a share or a right. The replacement of shares for rights, or vice versa, following a restructure would not qualify for roll-over relief as the essential characteristic of the employee's interests (shares or rights) provided after the restructure would have substantially changed.

1.256 The tax treatment of non-matching shares or rights immediately after a corporate restructure will be determined on the basis of the application of the base employee share scheme rules and will depend on the circumstances in each case.

1.257 A deferred taxing point will arise to the extent that the old shares or rights are replaced by cash that is matching, as roll-over relief only applies to matching shares or rights that are treated as a continuation of the shares or rights in the old company.

Example 1.38: Sale of subsidiary and employment relationships

Jeans Co is a wholly owned subsidiary of Clothing Co. The employees of both Clothing Co and Jeans Co have access to the employee share scheme run by Clothing Co. Clothing Co decides to sell off Jeans Co, and in anticipation of the sale, transfers some Clothing Co employees to Jeans Co, and some Jeans Co employees to Clothing Co.

Upon sale of Jeans Co by Clothing Co, the following would occur:

- employees of Clothing Co who have always worked for Clothing Co will have no cessation of employment;
- employees of Clothing Co who were originally employed by Jeans Co when they took part in the employee share scheme will have a cessation of employment;
- employees of Jeans Co who were always employed in Jeans Co will have no cessation of employment; and
- employees of Jeans Co who were employed by Clothing Co when they first took part in the employee share scheme will have a cessation of employment.

This is the same outcome as under the current law.

1.258 Where a taxpayer holds shares or rights in the old company that were acquired at different times, the matching shares or rights are also held to be acquired at those different times. The seven-year maximum deferral period will continue to run from the date the original shares or rights were acquired.

1.259 In 100 per cent takeover and restructure situations, the three-year minimum holding period for eligibility for the upfront concession is considered to have been met. ***[Schedule 1, item 1, subsection 83A-130(3)]***

1.260 If this were not the case, the disposal of old ESS interests at the point of takeover or restructure, albeit replaced by new ESS interests, may be regarded as a breach of the three-year minimum holding period and result in an employee's eligibility for the upfront concession being retrospectively amended by the Commissioner (see paragraphs 1.129 to 1.132 for the minimum holding period).

Old interest not matched by new interests

1.261 The old interests can be considered to have been disposed of (in connection with the takeover or restructure) if they can reasonably be regarded as matching any of the old interests but do not meet the criteria to be considered a continuation of those interests. ***[Schedule 1, item 1, subsection 83A-130(5)]***

1.262 Employment in the new company, a subsidiary of the new company; a holding company (within the meaning of the *Corporations Act 2001*) of the new company; or a subsidiary of a holding company of the new company is to be treated as a continuation of the employment in respect of which the old interests were acquired. ***[Schedule 1, item 1, subsection 83A-130(6)]***

1.263 The employee must continue be employed (within the meaning given above) at or about the time the new interest are acquired for the takeover and restructure rules to apply. ***[Schedule 1, item 1, paragraph 83A-130(9)(a)]***

Apportionment of cost base of old interests

1.264 Any consideration the employee paid for the ESS interests will be spread among the matching ESS interests in proportion to their market values immediately after the corporate restructure. This allows the calculation of the discount that is to be brought to tax to be calculated for those ESS interests that will not be subject to the roll-over and those that will. ***[Schedule 1, item 1, subsections 83A-130(7) and (8)]***

1.265 This only applies to employees who, at the time they acquire the new interests, do not hold a beneficial interest in more than 5 per cent of

the shares in the new company, and are not in a position to cast more than 5 per cent of the maximum number of votes that could be cast at a general meeting of the new company. ***[Schedule 1, item 1, subparagraphs 83A-130(9)(b)(i) and (ii)]***

Protecting the integrity of employee share schemes

1.266 The employee share scheme tax law is designed to ensure the integrity of the taxation of employee share schemes. The new law reproduces a number of integrity provisions in the current law and introduces a number of new integrity provisions.

Interests provided to associates

1.267 The new law continues to treat employee share scheme interests provided to associates of employees, in relation to an employee's employment, as though the interest was in fact acquired by the employee rather than the associate. ***[Schedule 1, item 1, section 83A-305]***

1.268 This provision is designed to ensure that arrangements are not artificially constructed to avoid the employee share scheme tax rules, or to lessen a tax liability incurred in relation to ESS interests, by providing benefits to associates of an employee.

1.269 The definition of 'associate' aligns with the broad definition used across the tax law (see section 318 of the ITAA 1936).

1.270 The employee share scheme arrangements expressly exclude an employee share trust from being considered an associate of an employee. ***[Schedule 1, item 1, section 83A-305]***

1.271 The employee share scheme rules tax employees who have a beneficial interest in an employee share trust as though they were the legal owners of those shares. Disregarding the employee share trusts under the associates provision ensures that the various employee share scheme rules do not inappropriately apply to the employee share trust. For further discussion on the treatment of trusts, see paragraphs 1.275 to 1.280.

1.272 If an employee share trust were not disregarded as an associate, potentially every employee would be taxed on every interest in the trust, as the trust would be an associate of the employees.

1.273 Unlike the old law, which always taxed the employee upfront for shares provided to an associate, the new law allows for deferral if the employee share scheme meets the criteria.

1.274 At the taxing point, when the shares move into the CGT system, any further capital gain or loss incurred in relation to the shares is borne by the associate. This is the same as under the current law.

Interests in a trust

1.275 The new law is designed to ensure that employees with a beneficial interest in shares in an employee share trust will be taxed as though they were the legal owners of those shares. This is so that employees cannot lessen, delay or avoid their tax liability by interposing a trust.

1.276 An ESS interest is defined as a *beneficial* interest so that an individual pays tax on shares or rights that they are receiving economic benefit from, regardless of whether they are also the legal owner of the shares or rights, or whether those shares or rights are held in a contractual or trust relationship for them. ***[Schedule 1, item 1, subsection 83A-10(1)]***

1.277 Further, to overcome trust law restrictions on identifying assets for which an employee holds a beneficial interest when they are held within a single pool of unidentifiable assets in a trust, the new law treats particular shares or rights to acquire shares in a trust as though they were beneficially owned by particular employees. ***[Schedule 1, item 1, subsections 83A-320(1), (2) and (4)]***

1.278 In the case where a trust holds multiple classes of assets, the rules are applied separately to each class of assets. ***[Schedule 1, item 1, subsection 83A-320(3)]***

1.279 These rules apply to both Australian trusts and to foreign entities that are treated in a consistent manner to Australian trusts. Entities that have similar characteristics to employee share scheme trusts but are treated in a manner more consistent with a different Australian entity are not covered by these rules.

1.280 These provisions relating to trusts are restricted to employee share trusts (as opposed to other trusts) for reasons of integrity. If trusts that are not an employee share trust are utilised, the trust may be an associate of the employee, resulting in the employee being taxed on all the ESS interests in the trust.

Employer reporting

1.281 The new law requires employers who provide ESS interests to report certain information to the Commissioner, to enable the Commissioner to ensure that the employee share scheme rules are being complied with. ***[Schedule 1, item 5, section 392-1 in Schedule 1 to the TAA 1953]***

1.282 An employer who provides ESS interests to an employee during a year must, at the end of the year, and in certain cases at the end of a later year, report to the Commissioner and to the employee.

1.283 These reporting requirements boost the integrity of the taxation of share schemes, addressing concerns that the current employee share scheme rules are not being complied with and that the Commissioner is in a position to know the full extent of that non compliance. The reporting requirements will provide the Commissioner with the information to conduct data matching activities and ensure that employees comply with the rules.

1.284 The reporting requirements also allow the Commissioner to pre-fill tax returns to assist employees with their tax obligations.

1.285 Specifically, the rules require that the provider of the ESS interests is the entity required to report. Whether the provider of an ESS interest is the employee's employer, or a holding company of the employer, will depend on the circumstances of the case.

Example 1.39: Employee share trust is not the provider

> Lee works for Party Co. Party Co has an employee share scheme which provides Lee with ESS interests through an employee share trust. Party Co is the provider, and is the entity required to report.

Example 1.40: Holding company may be the provider

> Emma works for Disco Co, which is fully owned by Dance Co. Dance Co operates an employee share scheme for employees of all its subsidiary companies, and directly offers Emma shares in Dance Co through an employee share scheme. Dance Co is the provider.

Example 1.41: Subsidiary employer may be the provider

> Alyse works for Sushi Co, a subsidiary of Japanese Food Co. Sushi Co operates an employee share scheme which offers its employees ESS interests in Japanese Food Co. Sushi Co is the provider.

Example 1.42: Share registry or other agent of the employer or holding company is not the provider

> Anna works for BBQ Co, and participates in BBQ Co's employee share scheme. BBQ Co contracts Share Registry Co to distribute Anna's ESS interests to her. BBQ Co is the provider.

1.286 In practice however, a provider may use an agent to fulfil the reporting requirements on their behalf.

Example 1.43: Use of an agent

Garden Co is a multinational corporation, with an Australian subsidiary company, Flower Co. Garden Co operates an employee share scheme, and offers shares in itself to employees of Flower Co through the scheme.

Garden Co is the provider, but it may use Flower Co as an agent to fulfil its reporting obligations.

1.287 A provider must give a statement to the Commissioner and to the employee if:

- the provider provided interests to the employee during the year which were taxed under the employee share scheme tax rules; or
- the provider has provided deferred tax interests to the employee (during that income year or a previous income year), and the ESS deferred taxing point for the interests occurred during the year.

[Schedule 1, item 5, subsection 392-5(1) in Schedule 1 to the TAA 1953]

1.288 An administrative penalty applies to providers who fail to provide this statement. ***[Schedule 1, item 80, subsection 286-75(2BA) in Schedule 1 to the TAA 1953]***

1.289 The statement must be provided in a form approved by the Commissioner, containing any required information or signed declarations, and provided to the Commissioner in the required manner. ***[Schedule 1, item 5, subsection 392-5(2) in Schedule 1 to the TAA 1953]***

1.290 The legislation outlines some of the particular information that the Commissioner may require in the approved form. This is provided to better illustrate the intent of the employer reporting requirements, and to provide some guidance to employers and employees as to the sort of information the Commissioner might require. ***[Schedule 1, item 5, subsection 392-5(3) in Schedule 1 to the TAA 1953]***

1.291 The legislative guidance that is provided on what the Commissioner may require in the approved form does not in any way limit the information that the Commissioner may or may not require. ***[Schedule 1, item 5, subsection 392-5(4) in Schedule 1 to the TAA 1953]***

1.292 The required statements must be given by the provider to the employee no later than 14 July after the end of the year; and to the Commissioner no later than 14 August after the end of the year. If the employer is unable to meet the deadline the Commissioner may defer the

deadlines under the general machinery provisions. The year is the financial year in which the ESS deferred taxing point for the ESS interest occurs. ***[Schedule 1, item 5, subsections 392-5(5) and (7) in Schedule 1 to the TAA 1953]***

1.293 The provider may disregard the 30-day rule for the ESS deferred taxing point (see paragraphs 1.201 to 1.202) for reporting purposes, if they are not aware when or whether the employee disposed of the ESS interest within 30 days of the ESS deferred taxing point. ***[Schedule 1, item 5, subsection 392-5(6) in Schedule 1 to the TAA 1953]***

1.294 If, after providing the statement, the provider becomes aware of any information that has materially changed or been omitted in the statement, within 30 days of becoming aware of the change or omission they must either inform the employee and the Commissioner; or provide the omitted information to the employee and the Commissioner. ***[Schedule 1, item 5, section 392-10 in Schedule 1 to the TAA 1953]***

1.295 The reporting requirements will apply to all ESS interests which are provided after 1 July 2009 and taxed upfront, or any ESS interest on which tax is deferred and relevant ESS deferred taxing point occurs after 1 July 2009. This includes ESS interests which may have been acquired under the current provisions in Division 13A of the ITAA 1936 (see paragraphs 1.391 to 1.422 for the transitional arrangements).

1.296 If the provider is an Australian parent company that has provided interests to foreign resident employees of a foreign subsidiary, and the employment is not considered to be Australian sourced income, then there will be no inclusion of the discount in the employee's assessable income, and no reporting requirement arises.

1.297 The employee share scheme rules relating to takeovers and restructures, discounted shares or rights acquired by associates, market values and discounts, trusts, relationships similar to employment, to stapled securities, and to indeterminate rights also apply for the purposes of employer reporting requirements. ***[Schedule 1, item 5, section 392-15 in Schedule 1 to the TAA 1953]***

TFN withholding tax (ESS)

1.298 The new law introduces a withholding tax, applicable in limited circumstances, to ensure the integrity of the taxation of employee share schemes.

1.299 The 'TFN withholding tax (ESS)' is defined in the TAA 1953, and is hereafter referred to as the withholding tax.

1.300 The withholding tax is payable if an employer provides discounted shares and rights to an employee, and that employee has not quoted their TFN, or their ABN to the employer by the end of the income year. ***[Schedule 1, item 2, subsections 14-155(1) and (3) in Schedule 1 to the TAA 1953, and clause 3 of the Income Tax (TFN Withholding Tax (ESS)) Bill 2009]***

1.301 An employee refusing to provide their employer with a TFN or ABN (as the case requires) undermines the new law relating to employer reporting requirements, which are important to ensuring the integrity of employee share scheme taxation.

1.302 If the employer does not report a TFN or ABN, the Commissioner will not easily be able to identify the employee to whom the discounted shares or rights have been provided (to ensure the correct tax is paid). Imposing a withholding tax in these cases will ensure that tax is in fact paid. The withholding tax is imposed in the income year that the employee would be liable to pay tax over the ESS assets.

1.303 It is rare for an employee to refuse to provide their employer with a TFN, so the withholding tax will not be commonly levied.

1.304 When the employer is a subsidiary of the provider of the employee share scheme, the employer may provide the employee's TFN to the provider, if the employee has provided their TFN number to the employer. ***[Schedule 1, item 2, section 14-160 in Schedule 1 to the TAA 1953]***

1.305 This rule makes the withholding tax requirements easier to comply with.

1.306 The withholding tax is payable on the amount of employee share scheme discount included in an employee's assessable income for an income year under the general employee share scheme tax rules. ***[Clause 3 of the Income Tax (TFN Withholding Tax (ESS)) Bill 2009]***

1.307 The employer may disregard the 30-day rule for the ESS deferred taxing point (see paragraphs 1.201 to 1.202) when determining whether any withholding tax is payable in an income year, if they are not aware when or whether the employee disposed of the ESS interest within 30 days of the ESS deferred taxing point. ***[Schedule 1, item 5, subsection 392-5(6) in Schedule 1 to the TAA 1953]***

1.308 The rate of withholding tax is calculated by adding the highest individual marginal tax rate to the rate of the Medicare levy. This rate ensures that high income individuals cannot pay less tax by withholding their TFN or ABN from their employer. ***[Clause 4 of the Income Tax (TFN Withholding Tax (ESS)) Bill 2009]***

1.309 For the purposes of the withholding tax, any upfront concession that may be available to the employee (reducing the amount of discount that is included in their assessable income) is disregarded. ***[Schedule 1, item 2, subsection 14-155(2) in Schedule 1 to the TAA 1953]***

1.310 This is because an employer who incurs withholding tax may not know whether or not the relevant employee meets the income test for the upfront concession.

1.311 Withholding tax is payable 21 days after the end of the income year in which the ESS interest is included in the employee's assessable income. This will be the year that the shares or rights were provided in the case of upfront taxation schemes, or the year of the ESS deferred taxing point for deferred tax schemes. ***[Schedule 1, item 2, subsection 14-155(4) in Schedule 1 to the TAA 1953]***

1.312 When withholding tax is levied on an employer, they can recover the amount of withholding tax that they have paid from the employee to whom the amount of tax relates. The employer can do this by offsetting the amount they can recover from the employee against an amount they otherwise owed the employee, such as the employee's salary. ***[Schedule 1, item 2, section 14-165 in Schedule 1 to the TAA 1953]***

1.313 Allowing the employer to recover the amount of withholding tax as a debt from the employee will mean that the tax is actually borne by the employee. This is appropriate as it is the employee who has the beneficial interest in the shares or rights, and the employee who will receive a tax credit for any withholding tax paid.

1.314 When calculating an employee's tax payable for an income year, the employee is given a credit for any withholding tax that has been paid by their employer in relation to them. ***[Schedule 1, item 2, section 14-170 in Schedule 1 to the TAA 1953]***

1.315 The withholding tax will generally result in the same financial outcome for the employer or the employee than they would otherwise have received had the employee provided their TFN or ABN. When withholding is levied:

- the employer will be able to recover a debt equal to any withholding tax paid from the employee; and

- the employee will receive a tax credit for withholding tax paid, which will be applied when the Commissioner makes their income tax assessment for the income year.

1.316 If there is an overpayment of withholding tax by the employer, the Commissioner must refund the amount that has been overpaid to the

employer, and the relevant employee will not receive a tax credit for that amount (nor will they have to pay any amount to the employer as a debt). ***[Schedule 1, item 2, section 14-175 in Schedule 1 to the TAA 1953]***

1.317 The employee share scheme rules relating to takeovers and restructures, discounted shares or rights acquired by associates, trusts, relationships similar to employment, to stapled securities, and to indeterminate rights also apply to the withholding tax. ***[Schedule 1, item 2, section 14-180 in Schedule 1 to the TAA 1953]***

1.318 Any withholding tax must be paid by a method provided for under the general machinery rules of the TAA 1953, and any amount of withholding tax that is not paid by the due date will result in the employer being liable for the general interest charge on the unpaid amount. ***[Schedule 1, items 3 and 4, subsection 16-70(3) and section 16-80 in Schedule 1 to the TAA 1953]***

Example 1.44: Operation of the TFN withholding tax (ESS)

Georgina is an employee of Ginger Bank in the 2009-10 income year. Ginger Bank operates an employee share scheme, and has provided Georgina with shares in Ginger Bank under an employee share scheme at a $100 discount to their market value. Ginger Bank's employee share scheme is an upfront taxation scheme. However, Georgina has not quoted her TFN to Ginger Bank by the end of the income year.

As a result, Ginger Bank is liable for withholding tax. Ginger Bank must pay this to the Commissioner no later than 21 days after the end of the income year.

The rate of the withholding tax will be 46.5 per cent in the 2009-10 income year.

Multiplying the discount Georgina received by the rate of the withholding tax will give Ginger Bank's withholding tax liability, so Ginger Bank must pay $46.50 to the Commissioner.

Ginger Bank may then recover $46.50 from Georgina as a debt. In this case, Ginger Bank and Georgina agree that $46.50 will be deducted from her salary.

When the Commissioner makes Georgina's income tax assessment for the 2009-10 income year, she will receive a tax credit of $46.50 in recognition of the withholding tax payed by Ginger Bank. Of course, the $100 discount she received through Ginger Bank's employee share scheme will be included in her assessable income.

In the end, Ginger Bank is no worse off, as they paid $46.50 to the ATO, and received $46.50 from Georgina. Once the ATO calculates Georgina's amount of tax payable for 2009-10, her tax outcome is no

different than it would have been had she provided her TFN or ABN to Ginger Bank in the first place. She will receive a credit from the ATO of $46.50, and will include the $100 discount in her assessable income (unless the upfront concession is applicable).

Interests may relate to past or prospective employers

1.319 An ***employee share scheme*** is defined as a scheme for providing ESS interests in a company to employees, including past or prospective employees, of the employer. ***[Schedule 1, item 1, subsection 83A-10(2)]***

1.320 The extension to past or prospective employees is an integrity measure to ensure that arrangements are not designed to occur before or after employment in order to avoid the employee share scheme rules. This is consistent with the general treatment of employment benefits elsewhere in the tax law, for example, in the FBTAA 1986.

Integrity rule about share trading and investment companies

1.321 Consistent with the current law, an employee will not be eligible for the upfront concession or deferred taxation if:

- the employee is employed by a company whose predominant business is the acquisition, sale or holding of shares, securities or other investments; and

- the employee is also employed by a subsidiary of that company, a holding company of that company, or an subsidiary of the holding company of that company.

[Schedule 1, item 1, subsection 83A-35(5) and paragraph 83A-105(1)(b)]

1.322 This rule prevents schemes which are contrived to provide employees with an interest in unrelated companies, through the establishment of share trading companies within the company group.

1.323 A holding company that holds shares in operating subsidiaries that are not investment companies will not itself be an investment company.

1.324 This integrity measure has been replicated from Division 13A of the ITAA 1936, where it was introduced to prevent a particular tax avoidance arrangement.

Refund of tax for forfeited shares

1.325 The new law provides for a refund of tax paid in relation to ESS interests in certain circumstances where those interests are forfeited after the employee has been taxed on the discount.

1.326 The refund is only available where the employee had no choice but to forfeit the ESS interest (except when that choice was to cease employment), and where the conditions of the scheme were not constructed to protect the employee from market risk.

1.327 Under such circumstances, the forfeited ESS interest is treated as never having been acquired, and the taxpayer can claim a refund of income tax by requesting that the Commissioner amend their income tax assessment to remove income previously included in their assessable income.

1.328 There is no time limit on amending an assessment to exclude an amount from a taxpayer's assessable income for a share interest which is forfeited, or for a right which was lost without being exercised. ***[Schedule 1, item 19, item 30 in the table in subsection 170(10AA) of the ITAA 1936]***

1.329 As the refund provisions are not intended to protect the employee from downside market risk, a refund will not be available where the share interest is forfeited due to a choice of the employee (except when that choice was to cease employment). Such a choice may include a choice not to exercise or dispose of an ESS interest, or some other choice of the employee that results in the forfeiture of the ESS interest.

1.330 Specifically, the new law is taken never to have applied in relation to an ESS interest (resulting in a refund of any previously paid income tax) where:

- an amount of employee share scheme discount has been, or would be, included in the employee's assessable income;
- the employee has either forfeited the ESS interest or, in the case of a right, the employee has lost the right without having disposed of or exercised it; and
- the forfeiture or loss is not the result of a choice made by the individual (except when that choice was to cease employment), and nor is it the result of a condition of the scheme that has the direct effect of wholly or partly protecting the employee from a fall in the market value of the ESS interest.

[Schedule 1, item 1, section 83A-310]

1.331 Whether or not forfeiture is as a result of a choice of an employee is something to be assessed on a case-by-case basis.

1.332 A choice to leave employment does not result in ineligibility for a refund. This provision recognises that in most cases a decision to leave employment will not primarily be based on the employee share scheme tax consequences of that decision, and that a refund of tax paid over the forfeited ESS interests in appropriate in such cases.

1.333 A situation in which an employee ceases employment primarily to avoid the employee share scheme rules, such to obtain a refund, only to recommence employment with the same employer shortly after, will likely be subject to the general anti-avoidance rules.

1.334 In situations where a refund is not available under the refund provisions, the taxpayer may be able to claim a capital loss under the CGT provisions.

Example 1.45: Genuine performance hurdle not met

Megan enters into an ESS arrangement with her employer, Motorcar Co. She will receive 1,000 Motorcar Co shares, subject to a performance hurdle requiring the company's market share to have increased in two years time. Megan cannot dispose of these rights in the two-year period.

Megan ceases employment after one year, triggering the ESS deferred taxing point, and pays tax on the discount she received for the 1,000 Motorcar Co shares and any subsequent gains (or losses). At the end of the two-year period, the market share of Motorcar Co did not increase and her rights to the shares are forfeited.

Eligible for refund: Yes. Megan has paid tax on the discount, could not have chosen to dispose of or exercise the rights prior to the two-year point, and forfeited the rights because a genuine performance hurdle was not met.

Example 1.46: ESS interest forfeited due a choice of the employee

Jane enters into an ESS arrangement with her employer, Tinderbox Co. She receives rights to 1,000 Tinderbox Co shares in one year, if she is still employed with Tinderbox Co at that time.

After one year, Jane has met this performance hurdle and pays tax on the discount she received on the rights to 1,000 Tinderbox Co shares because they are no longer at risk of forfeiture. She has a two-year window to exercise the rights to the shares. As the market price of Tinderbox Co shares remains below the exercise price for the duration of the two-year window, Jane decides not to exercise her rights.

Eligible for refund: No. The ESS interests were forfeited because of a choice made by Jane not to exercise the rights. Jane will be able to claim for a capital loss equal to the cost base of the rights.

Example 1.47: ESS interest forfeited due a choice of the employee

Azuma enters into an ESS arrangement with his employer, Plodder Co. Azuma receives shares in Plodder Co, but will forfeit them if he ceases employment with Plodder within the next three years. Azuma pays tax upfront because Plodder's scheme is not eligible for deferred tax.

Azuma leaves Plodder Co to work for Runner Co.

Eligible for refund: Yes. The ESS interest was forfeited because of Azuma's choice to cease employment. Azuma will be able to claim a refund for the tax paid over his shares.

Example 1.48: Condition of the scheme that protects the employee from market risk

Dane enters into an ESS arrangement with his employer, Frog Ltd. He will receive non-transferable rights over 1,000 Frog Ltd shares which will be forfeited if he ceases employment with Frog Ltd within one year. The rights can be exercised at anytime between one and six years after they were acquired, however the scheme restricts them from being exercised if the market price is below the strike price.

Dane holds the rights for six years. The market price never exceeds the strike price, and the rights lapse. Dane never had a choice to dispose of or exercise the rights as a condition of the scheme restricted him from doing so.

Eligible for refund: No. The condition of the scheme restricting Dane from exercising the right so long as the market price was below the strike price, had the direct effect of protecting Dane from any downside market risk. As Dane would lose money if he had chosen to exercise the rights when the market price was below the strike price, the condition of the scheme appears contrived to artificially restrict Dane from making that choice.

Example 1.49: ESS interest forfeited due to no choice of the employee

Katie enters into an ESS arrangement with her employer, Shoehorn Co. Katie receives non-transferable rights to 1,000 Shoehorn Co shares that will be exercisable in 10 years time. Katie will forfeit these rights if she ceases employment with Shoehorn Co in the next ten years.

Katie's rights are at real risk of forfeiture, and the scheme meets the other conditions for deferral, so she will defer tax until the ESS

deferred taxing point. The maximum time period for deferral is seven years, so she will pay tax on the discount at seven years.

After eight years Katie is made redundant and forfeits the rights which she has paid tax on.

Eligible for refund: Yes. Being made redundant was not a choice of Katie's, and she did not forfeit the rights due to a condition of the scheme with the direct effect of protecting her from downside market risk.

1.335 The rule which deems a taxpayer to have received market value for an asset when they receive no capital proceeds is turned off in cases where an ESS interest is forfeited. ***[Schedule 1, item 40, paragraph 130-80(4)(a)]***

1.336 The market value substitution rule is also turned off in relation to certain CGT events (E4, G1 and K8) to ensure that a employee who pays money to acquire ESS interests will receive a capital loss in respect of this payment if they forfeit those ESS interests. ***[Schedule 1, item 40, paragraph 130-80(4)(b)]***

Deduction by employers

1.337 Under the general income tax law, an employer could not deduct anything for directly providing shares or rights to shares in itself to its employees. This is because the issue of share capital would not be a loss or outgoing even though it relates to the remuneration of its employees. ***[Schedule 1, item 1, section 83A-200]***

Specific deduction

1.338 In order to encourage the provision of shares, stapled securities and rights to shares or stapled securities under certain employee share schemes, a limited specific deduction is provided to employers. An employer can deduct an amount for shares, stapled securities and rights to shares or stapled securities they provide to employees under an employee share scheme if the employee would be eligible for the upfront concession, disregarding the income test. ***[Schedule 1, item 1, subsection 83A-205(1)]***

1.339 The amount of the deduction is equal to the discount received by the employee on the security that they would not have had to include in their assessable income because the security came from a scheme that meet the conditions for the upfront concession detailed in paragraphs 1.114 to 1.136. The income test for the upfront concession is disregarded when determining an employer's eligibility to claim a deduction. ***[Schedule 1, item 1, subsections 83A-205(2) and (3)]***

1.340 The maximum deduction is $1,000 which is the maximum amount that an employee is entitled to reduce the discount included in their assessable income by.

1.341 If two or more employers jointly provide the security to an employee, the deduction is to be apportioned between them on a reasonable basis. ***[Schedule 1, item 1, subsection 83A-205(4)]***

Example 1.50: Deduction for joint providers

Alister receives 1,000 stapled securities from his employer, Taxation Services Pty Ltd, under an employee share scheme. Alister's adjusted taxable income is less than $180,000. The stapled securities are valued at $1 each and Alister has not had to pay anything towards acquiring them under the employee share scheme.

The employee share scheme has been provided on a non-discriminatory basis; Alister has no real risk of losing the stapled security; he has no other securities in his employer; he is required to hold the securities for at least 3 years; and the stapled security contains an ordinary share in Taxation Services Pty Ltd and a unit in a unit trust, Taxation Services Service Trust.

Alister would be entitled to reduce the $1,000 discount included in his assessable income from the acquisition of the stapled securities by $1,000.

The stapled securities were jointly provided by Taxation Services Pty Ltd and Taxation Services Service Trust (treated under the employee share scheme rules as one entity).

Taxation Services Pty Ltd and Taxation Services Service Trust would need to apportion the deduction between them. As the value of each component of the stapled security is equal, a reasonable apportionment would be for each to receive $500 deduction.

Timing of general deduction

1.342 A general deduction may be available in relation to the indirect provision of securities to employees under an employee share scheme, when an employer provides money to an employee share trust for the purpose of providing its employees with securities in itself. The employee share trust may acquire the securities by buying them on the market or by participating in a share issue by the employer.

1.343 An employer can generally deduct an amount of money or property (which is not a share in itself) provided to a employee share trust for the purpose of remunerating its employees under an employee share scheme.

1.344 The deduction would generally occur in the income year in which the employer incurred the loss or outgoing. However, this arrangement may allow an employer to artificially bring forward future deductions by making contributions to the trust that are in excess of its requirements under an employee share scheme.

1.345 To prevent an artificial bring forward of these deductions, the employee share scheme rules delay the deduction until the employee acquires an ESS interest. ***[Schedule 1, item 1, section 83A-210]***

1.346 The situations in which a deduction is deferred are not limited to cases involving an employee share trust. Any arrangement in which an employer provides ESS interests under an employee share scheme indirectly by providing another entity with money or property will result in a deduction being deferred until the employee acquires the security.

Foreign employment

1.347 Consistent with the treatment of most other types of income, whether an amount is included in a taxpayer's assessable income under the new employee share scheme rules will depend on the taxpayer's residency status and the source of the income.

1.348 Under the core rules of the Australian income tax system, an Australian resident taxpayer is subject to income tax on their worldwide income. A foreign resident taxpayer is only subject to Australian income tax on their Australian sourced income.

1.349 Under the existing law, this outcome is achieved by excluding discounts from interests acquired under employee share schemes from tax under the employee share scheme tax rules, to the extent that they relate to foreign service of a taxpayer.

1.350 This mechanism operates in a manner inconsistent with core rules. The new rules use the core rules to achieve the desired outcome. The new rules instead include source rules and rely on the core rules to the exclude foreign sourced income of foreign residents from Australian income tax. That is, the employee share scheme rules attribute a source to discounts received on securities acquired under employee share schemes.

1.351 To the extent that a discount on an ESS interest relates to employment outside Australia, the discount is taken to be from a foreign source. In the case of an ESS interest that is subject to a deferred taxing point, it is the amount included in your assessable income that is attributed a source (that is, both the discount and subsequent gains are attributed

with a source). The attribution is done in manner consistent with the rule applying to discounts. ***[Schedule 1, item 1, subsections 83A-25(2) and 83A-110(2)]***

1.352 The apportionment between foreign sourced and Australian sourced income is to be done in a manner consistent with Organisation for Economic Development and Cooperation (OECD) practice, as explained in the explanatory memorandum to the New International Tax Arrangements (Foreign-owned Branches and Other Measures) Bill 2005.

1.353 Source is attributed to amounts 'included' in assessable income either upfront or under the deferral method at the ESS deferred taxing point. The inclusion in assessable income is merely notional as all amounts included in assessable income must pass through the core rules before being taken into account in the calculation of taxable income. At this time foreign sourced income of foreign residents will be removed from the calculation of taxable income.

1.354 Whether the discount on the ESS interest acquired under an employee share scheme relates to employment in Australia or outside Australia is a question of fact that needs to be determined on a case-by-case basis.

1.355 Australian resident taxpayers are subject to Australian income tax on all discounts they receive under employee share schemes regardless of whether they received it in relation to employment in Australia or outside Australia. However, this may be affected by Australia's double tax treaties and the temporary residents rules.

1.356 Foreign resident taxpayers are only subject to Australian income tax on discounts they receive under employee share schemes to the extent that the discount relates to the employment in Australia. The core rules are contained in sections 6-5 and 6-10 of the ITAA 1997.

1.357 The outcome effectively mirrors the tax treatment of employment income. It has been necessary to modify the treatment of employee share scheme discounts received in respect of employment outside Australia in order to bring the employee share scheme rules into closer alignment with the ordinary treatment of salary and wage income and to prevent taxpayers avoiding the recent changes to section 23AG of the ITAA 1936 (exemption for foreign employment income).

Example 1.51: Foreign source income

Bob is a foreign resident and works for a multinational company, Mimosa Co in Hong Kong.

Bob receives 1,000 shares in Mimosa Co under Mimosa Co's employee share scheme for no consideration. The 1,000 shares relate to Bob's employment with Mimosa Co over the next 24 months and have a market value of $5,000. The shares are subject to forfeiture conditions.

One year after acquiring the shares under the employee share scheme, Mimosa Co transfers Bob to Australia for five months to work in Mimosa Co's Australian operations in Darwin. After the five month posting, Bob returns to Hong Kong.

At the end of the 24 months, the forfeiture conditions cease to apply and Bob and no disposal restrictions exist. The shares at this time are subject to an ESS deferred taxing point. The market value of the shares is $10,000 at the taxing point.

Bob notionally includes in his assessable income the full $10,000. The ESS rules attribute $2,083 (5/24) to be from an Australian source and $7,917 (19/24) to be from a foreign source.

As Bob is a foreign resident, only the $2,083 is included in his taxable income.

Temporary residents

1.358 The employee share scheme rules applying to temporary residents have been amended as a result of these reforms.

1.359 The temporary residents' provisions provide exemptions from Australian tax on foreign sourced income of individuals who are considered to be temporary residents of Australia for tax purposes.

1.360 These exemptions extend to CGT exemptions for capital gains realised on CGT assets that are not taxable Australian property. However, part of the capital gains realised on some shares and rights acquired under employee share schemes were excluded from these general exemptions. This was done to discourage the possible re-characterisation of employment income as a capital gain to avoid tax.

1.361 With the introduction of the new integrity rules applying to employee share schemes, the potential for taxpayers to exploit the temporary residents' rules has been minimised.

1.362 The current employee share scheme exceptions to the temporary residents are highly complex. They seek to only provide the exemption to the part of a capital gain realised on ESS interests that were subject to upfront taxation and accrued before a notional deferred taxing point. Replicating these rules within the new taxation framework would add significant complexity and compliance costs.

1.363 Given the new framework underlying the taxation of employee share schemes, it is no longer necessary to maintain these exceptions to the general temporary residents' exemptions. These amendments therefore repeal those exceptions. ***[Schedule 1, item 62]***

1.364 Capital gains realised on shares and rights acquired under an employee share scheme (after a taxing point has occurred under Division 83A) will be eligible for the temporary residents' CGT exemption similar to other CGT assets, regardless of whether a notional taxing point has occurred or not.

1.365 Consistent with other CGT assets, the temporary residents' exemptions will not apply to shares or rights acquired under an employee share scheme if those shares or rights are taxable Australian property.

1.366 There are also a number of other minor amendments made to the temporary residents rules to update referencing, to ensure its application to employee share scheme discounts applies in manner consistent with the treatment of salary and wages and to ensure that the cost setting rules within the employee share scheme rules interact correctly with those in the temporary residents' rules. ***[Schedule 1, items 60 and 61 and 63 and 64]***

Miscellaneous

Employment benefits that later become ESS interests

1.367 At the time of acquisition it may be unclear whether a right to an employment benefit will result in the receipt of an ESS interest, or it may be unascertainable how many ESS interests will be received. In such circumstances, that right will be considered to have been an ESS interest from the time that the original right to an employment benefit was acquired, if and when it becomes clear that the right to the employment benefit will result in the receipt of a definite number of ESS interests. ***[Schedule 1, item 1, section 83A-340]***

1.368 This is to ensure that employment benefits provided in the form of discounted shares or rights to shares are taxed consistently and appropriately under the employee share scheme rules.

1.369 This provision will apply, for example, to an employment benefit that is a right to an indeterminate number of shares, or to a benefit that may be received in shares, in cash, or in some other form.

1.370 When the nature of the right to an employment benefit as an ESS interest becomes clear, the Commissioner may amend an employee's income tax assessment for the income year in which the taxing point for the ESS interest occurred (based on the treatment of the right as an ESS interest from the time of its acquisition). The Commissioner can amend an assessment relating to an employee share scheme at anytime, for the purposes of a taxing an employment benefit which becomes an ESS interest. ***[Schedule 1, item 19, item 35 in the table in subsection 170(10AA) of the ITAA 1936]***

1.371 Reporting requirements apply to all ESS interests under new employee share scheme rules. If an employer becomes aware of an omission or change in any information provided to the Commissioner under the reporting requirements, such as if it becomes clear that a right provided to an employee in a previous income year was a right to ESS interests, the employer must inform the Commissioner of any change or omission as soon as possible. This information is to be provided in the approved form. ***[Schedule 1, item 5, section 392-10 in Schedule 1 to the TAA 1953]***

1.372 The shortfall interest charge may apply in situations where the Commissioner amends an employee's income tax assessment for an earlier income year to include additional amounts of assessable income that result in extra income tax becoming payable.

Example 1.52: Simple example

Faiza is granted rights to an indeterminate number of shares in her employer, Dishwasher Co. She will receive rights to a number of shares in two years time, calculated on a one-for-one basis with the number of dishwashers she sells over that period.

Over the two years Faiza sells 437 dishwashers, and as a result, receives rights to 437 shares in Dishwasher Co. She will work out whether she would be taxed upfront or defer tax under the employee share scheme rules, as though she had received rights to 437 Dishwasher Co shares two years earlier, at the time she received the original right.

Example 1.53: Deferral or upfront taxation

Miranda is granted rights to an indeterminate number of shares in her employer, Longhorn Co, as a part of her total employment remuneration package. Miranda already owns a 6 per cent stake in Longhorn Co.

The number of shares which Miranda will receive is calculated by reference to the increase in Longhorn Co's share price over five years.

In five years time, Longhorn informs Miranda that she has rights to 568 shares, calculated by reference to a formula in Longhorn Co's share policy. At that point, Miranda's rights are taken to always have been ESS interests.

Because Miranda has effective ownership of greater than 5 per cent of her employer, she is not eligible to defer tax over her ESS interests. Miranda would have been taxed upfront on these ESS interests.

Miranda will seek an amendment of her income tax assessment for the income year five years earlier to include an amount in relation to these ESS interests in her assessable income. Miranda is also not eligible for the upfront concession because she has effective ownership of greater than 5 per cent of her employer.

Example 1.54: Share appreciation rights

Caitlin is granted rights to an indeterminate number of shares in her employer, Redbooks Co, as a part of her total employment remuneration package. Caitlin receives this employment entitlement in January 2010. Caitlin will receive the rights to shares in three years time, provided she is still employed by Redbooks Co at that time.

The number of shares which Caitlin will be entitled to on exercise is calculated by reference to the increase in Redbook Co's share price over the three years.

Such a right to an indeterminate number of shares cannot be identified as specific right to a number of 'rights to shares', until such time as the number of shares which would be received on exercise of the right can be calculated.

In January 2013, Caitlin receives the rights to 988 shares, by reference to a formula in Redbook's share policy. At that point, Caitlin's rights to shares are taken to always have been ESS interests (rights to 988 shares).

Caitlin's rights were subject to a real risk of forfeiture (due to the condition requiring her to forfeit the rights if she left employment with Redbooks) when she acquired the ESS interest in January 2010, and would have deferred tax until the ESS deferred taxing point.

Caitlin now needs to work out when the taxing point for her ESS interests occurred or will occur.

Caitlin remained employed with Redbooks over the three-year period. During that period, she did not yet have the shares, did not know how many shares she would receive, and was restricted from selling or

exercising her rights to those shares. In January 2013 when Caitlin receives her 988 shares, she is not subject to any further restrictions on sale, and her ESS deferred taxing point occurs.

Caitlin will include an amount in relation to her ESS interests in her income tax assessment for the 2012-13 income year.

Example 1.55: Employment benefits that may or may not be received in ESS interests

Peter is employed by Bluebooks Co. As a part of his total employment remuneration package, he receives a right 10,000 Bluebook shares in 10 years time, if he remains employed with Bluebooks Co for that period. However, Bluebooks management reserves the right to grant Peter the cash value of the shares rather than actual Bluebooks Co shares.

As it is uncertain whether Peter will receive shares or cash, Peter does not have 'rights to shares'. As such, Peter's right cannot yet be characterised as an ESS interest.

Peter remains employed with Bluebooks for 10 years, and receive the rights to 10,000 shares. It is now considered that Peter acquired the rights to these shares 10 years previously, and that these rights were always ESS interests provided under an employee share scheme.

Peter now needs to work out when the taxing point on the rights to his shares occurred. Since he was required to remain employed by Bluebooks Co, Peter's rights were at real risk of forfeiture and he was eligible to defer tax on those rights. Since Peter did not have the ability to sell his rights during the 10 years, the first deferred taxing point for Peter would have occurred seven years after he acquired the rights to the shares (the maximum period of deferral). Peter's income tax assessment for three years ago must therefore be amended to include an amount in relation to the rights to 10,000 Bluebook shares.

Example 1.56: The ESS deferred taxing point operates as though the right was always an ESS interest

Odon is employed by Drover Co. As a part of his total employment remuneration package, he receives a right 50,000 Drover shares in seven years time, if Drover Co's share price increases by 30 per cent or greater over that time. However, Drover management reserves the right to grant Odon the cash value of the shares rather than actual Drover Co shares.

As it is uncertain whether Odon will receive shares or cash, Odon does not have 'rights to shares'. As such, Peter's right cannot yet be characterised as an ESS interest.

Four years after acquiring the right, Odon ceases employment with Drover Co.

Seven years after acquiring the right, Drover Co's share price has increased by 50 per cent, and Odon receives the rights to 50,000 shares. It is now considered that Odon acquired the rights to these shares seven years previously, and that these rights were always ESS interests provided under an employee share scheme.

Odon now needs to work out when the taxing point on the rights to his shares occurred.

Since Odon would have forfeited his rights if Drover's share price did not increase by 30 per cent, Odon's rights were at real risk of forfeiture and he was eligible to defer taxation on those rights.

Although Odon was not able to sell his ESS interests during the seven years, he ceased employment with Drover Co four years after acquiring the rights, triggering the ESS deferred taxing point.

Odon will seek an amendment of his income tax assessment for the income year in which he ceased employment, to include an amount in relation to his ESS interests in his assessable income.

Example 1.57: No ESS interests are received

Chikako is granted a right to shares in her employer, Foxhound Co, as a part of her total employment remuneration package. Chikako will receive the shares in three years time, provided she meets certain performance hurdles. However, Foxhound Co management reserves the right to grant Chikako the cash value of the shares rather than actual Foxhound Co shares.

Chikako fails to meet her performance hurdles, and receives neither Foxhound Co shares nor a cash payment in lieu. She does not have any ESS interests, and will not be taxed under the employee share scheme rules.

Example 1.58: No ESS interests are received

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.

Relationships similar to employment

1.373 The employee share scheme rules cover not only employees of a company offering an employee share scheme, but also cover employees in relationships similar to employment. ***[Schedule 1, item 1, section 83A-325]***

1.374 This is to ensure that people such as directors or office holders who are not considered employees, but who are in an employee-like relationship are not excluded from participating in employee share schemes.

1.375 The rules also cover taxpayers who are independent contractors.

Ceasing employment provision

1.376 An employee is considered to have ceased employment when they are no longer employed either by their employer, a holding company or subsidiary of their employer, or a subsidiary of a holding company. ***[Schedule 1, item 1, section 83A-330]***

Stapled securities

1.377 Stapled securities are treated in the same way as shares under the employee share scheme rules provided at least one of the elements of the stapled security is a share in a company. This limitation is necessary in order to maintain the necessary link of the rules with acquisitions of interests in corporate entities. ***[Schedule 1, item 1, subsection 83A-335(1)]***

1.378 In other words, these stapled securities acquired under an employee share scheme are subject to the employee share scheme rules as if the stapled security were a share in a company. Rights to stapled securities are treated in the same way as rights to shares.

1.379 Employees who receive a stapled security under an employee share scheme must therefore include in their assessable income any discount received on acquisition of that security.

1.380 A condition for eligibility for any of the employee share scheme tax concessions is that the security acquired under the scheme relates to an ordinary share. In the case of a stapled security, it meets this condition if the stapled security is made up of share that is an ordinary share. ***[Schedule 1, item 1, subsection 83A-335(2)]***

1.381 The stapled security includes interests in two or more entities. For the purposes of the employee share scheme rules, these entities are taken to be one single entity. More specifically, the non-corporate entities are taken to be parts of the corporate entity. This allows, amongst other

things, for the employment conditions to be satisfied. ***[Schedule 1, item 1, subsection 83A-335(3)]***

1.382 As a result of consultation, the new employee share scheme rules have been applied more broadly than the previous employee share scheme rules. The employee share scheme rules apply to a wider class of stapled securities.

Example 1.59: Stapled securities

Kim is employed by Kiwi Dairy Property Trust in Bega. Units in Kiwi Dairy Property Trust are stapled with shares in Kiwi Dairy Limited. Kim acquires 2,000 stapled securities under an employee share scheme. The securities have a market value of $1.50 per security and Kim has paid 50¢ towards each security.

As each stapled security contains at least one share in a company, the stapled security is covered by the employee share scheme rules in the same way as the employee share scheme rules apply to shares.

Therefore, the discount Kim receives on the acquisition of the securities must be included in her assessable income ($2,000).

However, the employee share scheme and Kim's acquisition of the security meet the conditions for deferral of the taxing point including because Kim's employment is taken to be with a company (as employee share scheme rules treat the trust as part of the company) and the share in Kiwi Dairy Limited is an ordinary share.

Kim must defer including the discount in her assessable income until the deferred taxing point occurs.

Entities treated like companies

1.383 In certain cases and for various reasons, the tax law treats particular classes of particular entities as companies. Most often, this is for reasons of integrity.

1.384 Examples of this are corporate limited partnerships and corporate unit trusts and public trading trusts under the consolidation rules. Under the corporate limited partnership rules and the consolidation regime rules dealing with corporate unit trusts and public trading trusts, those entities are treated as companies for all tax law purposes. This includes treating interests in those entities as shares in a company.

1.385 The employee share scheme rules therefore also apply to interests in these entities acquired under employee share schemes in the same way as the rules apply to shares in companies.

Example 1.60: Entities treated like companies

Litsa is employed by AF & TS remuneration specialists which is a corporate limited partnership.

Litsa receives an interest in the corporate limited partnership under an employee share scheme (i.e., she buys into the partnership). The interest is provided to Litsa at a 10 per cent discount to the market value.

The discount is included in Litsa's assessable income in the year she acquired the interest. The interest is not subject to forfeiture conditions and Litsa is not required to hold the interest for a minimum period.

1.386 There has been no change to the treatment of these types of entities under the new employee share scheme rules.

Ability to amend income tax assessment

1.387 There is no limit to when the Commissioner can amend an assessment relating to an employee share scheme, for the purposes of the refund provisions. ***[Schedule 1, item 19, item 30 in the table in subsection 170(10AA) of the ITAA 1936]***

1.388 Since the tax on an ESS interest can be deferred for up to seven years, and it will not be known before hand whether or not shares will be forfeited, it is inappropriate to limit the period to which an income tax assessment can be amended.

1.389 The Commissioner can also amend an assessment relating to an employee share scheme at anytime, for the purposes of a taxing an employment benefit which becomes an ESS interest. See paragraphs 1.367 to 1.372 for the treatment of rights that later become ESS interests. ***[Schedule 1, item 19, item 35 in the table in subsection 170(10AA) of the ITAA 1936]***

1.390 These provisions are not limited to the direct tax levied by the employee share scheme rules, but also includes flow-on effects to other tax which the employee share scheme rules might give rise to.

Application and transitional provisions

1.391 The new employee share scheme rules apply to ESS interests acquired on and after 1 July 2009. ***[Schedule 1, item 83, paragraph 83A-5(1)(a) of the IT(TP)A 1997]***

1.392 A tiebreaker rule provides that if the time of acquisition differs between the new and the current law, the time of acquisition under the current law will be used and the time of acquisition under the new law will be disregarded. That is, if a share or right was acquired under the current law before 1 July 2009, and under the new law the ESS interest was acquired after 1 July 2009, the old law continues to apply to that arrangement. ***[Schedule 1, item 83, paragraph 83A-5(1)(b) of the IT(TP)A 1997]***

1.393 This rule will provide clarity in any unforeseen circumstances where the dates of acquisition may differ between the two regimes.

Example 1.61: Acquisition tiebreaker

Michelle acquired shares in her employer under an employee share scheme. The rules in Division 13A consider her to have acquired the share on 20 June 2009. The new employee share scheme rules consider her to have acquired the ESS interest on 25 July 2009.

The tiebreaker transitional provision provides that she is considered to have acquired the shares on 20 June 2009 under the Division 13A rules, and not under the new employee share scheme rules in Division 83A.

Shares and rights transitioned to the new rules

ESS interests over which tax is being deferred are transitioned to the new rules

1.394 Shares or rights acquired before 1 July 2009, on which tax has been deferred beyond 1 July 2009, will be brought within the new employee share scheme rules. This will simplify the law and improve the interaction of the employee share scheme rules with other areas of the law. ***[Schedule 1, items 83 and 86, subsections 83A-5(2) and (3) of the IT(TP)A 1997]***

Current taxing points are preserved

1.395 An employee who acquired shares or rights under the current employee share scheme rules (Division 13A of the ITAA 1936), or the previous employee share scheme rules (section 26AAC of the ITAA 1936), will continue to pay tax at the time determined by reference to those previous rules. ***[Schedule 1, item 83, paragraph 83A-5(4)(b) of the IT(TP)A 1997]***

1.396 However, the new 30 day rule in the ESS deferred taxing point rules will apply to the old taxing points for transitioned shares or rights. The deferred taxing point for the ESS interest is moved to the time the employee disposes of the interest, if they dispose of the interest within

30 days after the original deferred taxing point. ***[Schedule 1, item 83, paragraph 83A-5(4)(c) of the IT(TP)A 1997]***

1.397 Applying the new 30-day rule to transitioned shares and rights will assist in preserving the effect of the special market valuation rules that existed in Division 13A. It also lowers the probability that shares or rights will in subject to multiple taxation regimes in very short periods of time.

Example 1.62: Application of previous taxing point

> Mark acquired shares or rights in his employer under an employee share scheme on 31 January 2002. Division 13A of the ITAA 1936 applied to his scheme, his scheme was a qualifying scheme and Mark elected to defer tax. Under Division 13A, Mark expected his cessation point to occur on 31 January 2012 (subject to him remaining in employment).
>
> Mark's shares and rights will be transitioned into the new employee share scheme rules. The transitional provisions will ensure that his taxing point will still occur when it otherwise would have, on 31 January 2012 (subject to his remaining in employment).
>
> If Mark disposed of his shares or rights within 30 days of his original taxing point, for example on 5 February 2012, the deferred taxing point will be the time of disposal.

Refund provisions are preserved

1.398 Transitional provisions have also been included to ensure the introduction of the new law will not affect an employee's eligibility for a refund in respect of rights they acquired prior to 1 July 2009. Employees may claim a refund of tax paid on the right, if they forfeit the right and a refund would have been available under the rules applying at the time that they acquired the right. ***[Schedule 1, item 83, paragraph 83A-5(4)(d) of the IT(TP)A 1997]***

Example 1.63: Refund provisions

> Lee acquired rights in her employer under an employee share scheme in 2004. Division 13A of the ITAA 1936 applied to her scheme, her scheme was a qualifying scheme and she elected to defer tax. She did not have a cessation time prior to 1 July 2009, so her rights are transitioned into the new rules.
>
> In 2010 Lee ceases employment, triggering the cessation time, and Lee pays tax on her rights.

In 2011 Lee allows her rights to lapse without having exercised them. As she would have been able to claim a refund of tax under Division 13A, she will be able to claim a refund of tax under the transitional provisions.

Foreign employment provisions are preserved

1.399 Consistent with the current law, employees will not pay tax on shares and rights that have been transitioned into the new rules to the extent that the shares or rights relate to the employee's employment outside Australia. ***[Schedule 1, item 83, paragraph 83A-5(4)(a) of the IT(TP)A 1997]***

TFN withholding tax (ESS) does not apply

1.400 The requirement for employers to withhold TFN withholding tax in situations where the employee has not quoted their TFN, or their ABN to the employer by the end of the income year does not apply to shares and rights that have been transitioned into the new rules. ***[Schedule 1, item 83, paragraph 83A-5(4)(e) of the IT(TP)A 1997]***

1.401 As employers will not necessarily know whether or not an employee has elected to be taxed upfront or to defer tax under the current rules, they may not know whether they are required to withhold tax.

Shares or rights acquired under section 26AAC are not excluded from being employment termination benefits

1.402 Consistent with the current law, shares or rights acquired under section 26AAC of the ITAA 1936 transitioned into the new rules are not excluded from being employment termination payments. ***[Schedule 1, item 83, paragraph 83A-5(4)(g) of the IT(TP)A 1997]***

CGT acquisition date is preserved for certain shares and rights

1.403 The CGT acquisition date in relation to a transitioned share or right, acquired under Division 13A of the ITAA 1936 over which an employee had legal title at the time the share or right was acquired under the current ESS rules, will be the time at which the employee became legally entitled to the share or right. ***[Schedule 1, item 83, subparagraph 83A-5(4)(f)(i) of the IT(TP)A 1997]***

1.404 This rule prevents certain taxpayers from having their CGT acquisition date for shares or rights retrospectively amended by operation of the new employee share scheme rules.

Certain new rules apply to transitioned shares or rights

1.405 The new rules relating to, among other things, employer reporting and calculating the amount to include in assessable income will apply to those shares or rights which have been brought within the new rules.

1.406 Applying the new reporting rules to shares or rights which have been brought within the new rules will assist the Commissioner in ensuring the correct tax is paid in relation to those shares or rights.

1.407 As an employer will not know whether or not an employee has elected to be taxed upfront or to defer tax under the current employee share scheme rules, the employer is required to report shares or rights with a possible cessation time, regardless of whether the shares or rights were in fact taxed upfront. ***[Schedule 1, item 83, subparagraph 83A-5(4)(f)(ii) of the IT(TP)A 1997]***

1.408 The Commissioner will consult on the design of the approved form to assist employers covered by these arrangements.

1.409 When calculating the amount to include in assessable income the new rules will apply. That is, at the deferred taxing point (which may be determined by reference to Division 13A or section 26AAC of the ITAA 1936), the market value of the shares or rights is reduced by the cost base of the shares or rights. When determining market value the new arrangements will apply (see paragraphs 1.106 to 1.113).

Employment benefits that later become ESS interests

1.410 Sometimes it is unclear at the time of acquisition of a right whether will be received in the form of an ESS interest, or it may unclear how many ESS interests will be received as a result of its exercise. If it becomes clear that the right will be received in a definite number of ESS interests, it is taxed under the employee share rules as though it were always clearly as ESS interest. See paragraphs 1.367 to 1.372 for further discussion of these types of benefits.

1.411 This provision would apply, for example, to an employment benefit that is a right to an indeterminate number of shares, or to a benefit that may be received in shares, in cash, or in some other form. The provision ensures that employment benefits provided in the form of discounted shares or rights to shares are taxed consistently.

1.412 When the nature of the right to an employment benefit as an ESS interest becomes clear, the Commissioner may amend an employee's income tax assessment for the income year in which the taxing point for

the ESS interest occurred (based on the treatment of the right as an ESS interest from the time of its acquisition). The Commissioner can amend an assessment relating to an employee share scheme at anytime, for the purposes of a taxing an employment benefit which becomes an ESS interest.

1.413 Rights acquired prior to 1 July 2009, which only clearly become ESS interests after 1 July 2009 (by operation of this rule) will be subject to the current employee share scheme rules. If the operation of the current rules would have them defer tax over 1 July 2009, they will be transitioned into the new rules, consistent with other transitional rights or shares. ***[Schedule 1, item 83, section 83A-15 of the IT(TP)A 1997]***

Example 1.64: Employment benefits that later become ESS interests may be transitioned to the new rules

Lyra is granted a non-transferable right to 4,000 shares in her employer, Waterworks Co, as a part of her total employment remuneration package.

Lyra receives this right in January 2008.

Lyra will forfeit the right is she ceases employment with Waterworks Co within five years of acquiring the right. However, Waterworks management reserves the right to grant Lyra the cash value of the shares rather than actual Waterworks Co shares.

As it is uncertain whether Lyra will receive shares or cash, Lyra does not have 'rights to shares'. As such, Lyra's right cannot be characterised as an ESS interest, or as a right to shares under Division 13A of the ITAA 1936, when it is acquired.

Lyra remains employed with Waterworks Co for the five-year period, and receives rights to 4,000 Waterworks shares in January 2013, as Waterworks management decides not to exercise their discretion to provide the benefit in cash instead. She is now considered to have acquired her ESS interests in January 2008. In January 2008 her shares would have been subject to the current employee share scheme rules (Division 13A of the ITAA 1936).

Lyra now needs to work out when the taxing point for her rights occurred or will occur under the current employee share scheme rules.

Once Lyra receives her rights to shares in January 2013, she is not subject to any restrictions on their disposal.

Lyra remained employed with Waterworks Co over the five-year period. Since Lyra did not have the ability to sell her rights during the five years, her first cessation point would have occurred five years

after she acquired the rights to the shares (when she was no longer subject to any restrictions on the disposal of the rights).

Lyra now knows that while at acquisition her rights were subject to the current employee share scheme rules, tax was deferred on these rights over 1 July 2009. This means that they will be transitioned into the new employee share scheme rules.

Lyra will treat her rights as transitional ESS interests. She will include an amount in her assessable income for the 2012-2013 income year. Her rights are subject to the new employee share scheme rules, however the taxing point, refund provisions, foreign employment provisions and CGT acquisition date are as they would have been under the current rules.

Example 1.65: Employment benefits that later become ESS interests may be taxed under previous regimes

Dexter is granted a non-transferable right to 8,000 shares in his employer, Cannonball Co, as a part of his total employment remuneration package. However, Cannonball management reserves the right to grant Dexter the cash value of the shares rather than actual Cannonball Co shares.

Dexter receives this right in December 2006.

Dexter will be able to exercise his right to shares in three years time, irrespective whether he is still employed by Cannonball Co at that time.

Dexter ceases employment with Cannonball Co in December 2007.

Dexter receives rights to 8,000 Cannonball shares in December 2009, as Cannonball management decides not to exercise their discretion to provide the benefit in cash instead. He is now considered to have acquired his ESS interests in December 2006. In December 2006 his shares would have been subject to the current employee share scheme rules (Division 13A of the ITAA 1936).

Dexter now needs to work out when the taxing point for his rights occurred or will occur under the current employee share scheme rules.

Since Dexter did not have the ability to sell his rights during the three years, his first cessation point would have occurred when he ceased employment with Cannonball Co. in December 2007.

Dexter will seek an amendment of his income tax assessment for the 2007-2008 income year to include an amount in relation to these ESS interests in his assessable income. Dexter is taxed under the current (Division 13A) employee share scheme rules, as those rules were in force in December 2007.

Current rules continue to apply to non-transitioned shares and rights

1.414 The current rules will continue to apply to shares or rights which are not being brought into the new rules. That is, shares or rights on which tax was paid under Division 13A of the ITAA 1936 will continue to be subject to those rules. The previous rules contained in section 26AAC of the ITAA 1936 will continue to apply to shares or rights acquired under those rules which are not being brought into the new rules. ***[Schedule 1, item 83, subsection 83A-10 of the IT(TP)A 1997]***

1.415 Given that tax has already been paid on the untransitioned shares and rights under the previous regimes, their ongoing application will provide certainty to employees taxed under these regimes.

Consolidation rules in the current law continue to apply

1.416 The tax law provides rules to ensure that shares and rights provided under an employee share scheme are disregarded for the purposes of establishing whether a company is a wholly-owned subsidiary of another. These rules ensure that company groups whose subsidiary companies offer employee share schemes are not prevented from consolidating for tax purposes merely because the holding company does not hold 100 per cent of the subsidiary because of shares or rights provided to employees under an employee share scheme.

1.417 Transitional provisions have been included to ensure that the current rules relating to consolidation, that apply to shares acquired under Division 13A, continue to apply to shares and membership interests that it applied to prior to the introduction to the new law. These provisions apply to both the consolidated groups and multiple entry consolidated groups (MEC groups). ***[Schedule 1, items 84 and 85]***

Retrospective regulations will apply

1.418 Regulations made for the purposes of, or relating to, the new employee share scheme rules may have retrospective effect from 1 July 2009, if they are made within three months from the date that these Bills receive Royal Assent. ***[Schedule 1, item 87]***

1.419 The Government has announced that it will replicate the rules for valuing unlisted shares or rights in the Regulations as an interim measure pending the recommendations of the Board of Taxation in relation to these valuation methods.

1.420 To ensure that appropriate valuation methods are provided for unlisted shares and rights acquired or disposed of between 1 July 2009

and the date that these Bills receive Royal Assent, and to provide certainty to providers and employees participating in employee share schemes, these Regulations will have retrospective effect.

1.421 The general prohibition on retrospective regulations that adversely affect the rights or liabilities of a taxpayer does not apply to these Regulations, provided that they are made within three months of these Bills receiving Royal Assent.

1.422 This is considered appropriate because the purpose of the Regulations is to provide certainty to providers and employees participating in employee share schemes. Draft versions of the Regulations were made available to the public for comment on the Treasury website on 14 August 2009.

Consequential amendments

Other amendments

1.423 There are also amendments tidying up assorted references, headings, notes and other things that need to be removed or changed because the employee share scheme rules have been rewritten into the ITAA 1997, and because the terminology used to refer to concepts in the new employee share scheme rules is different and references must be updated. ***[Schedule 1, items 6, 7, 9, 10, 12 to 18, 20 to 22, 24 to 39, 41 to 59, 65, 67 to 79, 81 and 82]***

Chapter 2
Non-commercial losses

Outline of chapter

2.1 Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to tighten the application of the non-commercial losses rules in relation to individuals with an adjusted taxable income of $250,000 or more. These amendments will prevent high income individuals from offsetting deductions from non-commercial business activities against their salary, wage or other income.

2.2 All references are to the ITAA 1997 unless otherwise stated.

Context of amendments

2.3 The non-commercial losses rules were introduced in 2000, following recommendations from the *Review of Business Taxation*. They are aimed at improving the integrity, fairness and equity of the tax system, by addressing the opportunity for individuals to avoid tax by carrying on unprofitable business activities and claiming deductions for losses arising from such activities against their other income.

2.4 Under the current non-commercial losses rules contained in Division 35 of the ITAA 1997, an individual carrying on a business activity either alone or in partnership has to quarantine losses to the business activity.

2.5 Exemptions exist, however, which allow taxpayers to apply losses from the business activity against their other income in an income year if the business activity satisfies at least one of four objective tests in that year, or if the Commissioner of Taxation (Commissioner) exercises a discretion. The four tests are:

- assessable income test — the assessable income generated from the activity must be at least $20,000;
- profits tests — the activity must have produced a profit in three of the last five income years;

- real property test — the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least $500,000; and
- other assets test — the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least $100,000.

2.6 If a business activity does not pass any of these tests, the Commissioner has a discretion to nonetheless allow a taxpayer to offset the losses against other income, having regard to certain circumstances. For example, if there are exceptional circumstances applicable to the business activity that stop it from meeting one of the four tests. Exceptional circumstances could include adverse weather conditions, such as drought or flood, that prevent a farming business from meeting the assessable income test in a particular year.

2.7 In addition, another exception is available when the taxpayer is involved in a primary production or professional arts business activity, and the taxpayer's total income from other sources is no greater than $40,000.

2.8 Currently, if any of the above tests are met, the taxpayer can deduct all of the expenses from their business activities from both the business and other income. If all of the tests are failed, the deductions are limited to the amount of the income from the business. It does not mean that the costs are not deductible, just that deductions are quarantined to the particular business activity. Quarantined deductions can be carried forward to be used against future income from that business activity or offset against other income once a test is met.

Consultation

2.9 An exposure draft of the proposed legislation was released for public consultation on 26 June 2009. The consultation period closed on 26 July 2009. Seventeen submissions to the consultation process were received.

2.10 Submissions raised concerns around the process for applying to the Commissioner, and the evidentiary burden for taxpayers applying for a discretion, including what constituted 'objective evidence'. The exposure draft has been amended to require applications to be made in an approved form. The form will help the taxpayer work out what information is required to be provided to the Commissioner to assess whether or not to exercise his or her discretion.

2.11 Submissions also raised concerns about the continued status of discretions obtained prior to the changes in this Bill; particularly in relation to 'managed investment schemes'. Transitional provisions now ensure that all previous discretions granted by the Commissioner will continue to apply.

2.12 Consultations also raised the issue of investment allowances under Division 41 of the ITAA 1997 being quarantined to a business activity that is otherwise profitable, but because of the investment allowances makes a tax loss. The exposure draft has been amended to carve-out those investment allowances for owners of otherwise profitable businesses.

Summary of new law

2.13 These amendments recognise that the current non-commercial loss rules apply in a discriminatory way, because taxpayers with high incomes are more able to meet one of the four objective tests. These amendments limit access to the four objective tests to individuals who meet an income requirement.

2.14 These amendments also provide the Commissioner with a new discretion in cases where an individual does not meet the income requirement, but can nonetheless independently demonstrate that their business is genuinely commercial.

Comparison of key features of new law and current law

New law	*Current law*
Individuals must look at their adjusted taxable income to see if they meet the income requirement. This will determine which tests apply in relation to their losses from their non-commercial business activity. The income requirement is met when an individual has an adjusted taxable income of less than $250,000 in the relevant income year.	There is no income requirement.
Four objective tests are used to work out if a business activity is commercial in nature. The objective tests are: • the assessable income test — the assessable income generated from the activity must be at least $20,000; • profits test — the activity must have produced a profit in three of the last five income years; • real property test — the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least $500,000; and • other assets test — the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least $100,000. Not all tests are available to all taxpayers. If an individual has an adjusted taxable income of less than $250,000 and one of the four objective tests is not met, losses from non-commercial business activities are quarantined. If an individual has an adjusted taxable income of $250,000 or more, losses from non-commercial business activities are quarantined.	Four objective tests are used to work out if a business activity is commercial in nature. The objective tests are: • the assessable income test — the assessable income generated from the activity must be at least $20,000; • profits test — the activity must have produced a profit in three of the last five income years; • real property test — the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least $500,000; and • other assets test — the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least $100,000. All taxpayers can access all four tests. Unless one of the objective tests is met, losses from non-commercial business activities are quarantined.

New law	***Current law***
Any individual with an adjusted taxable income of less than $250,000 may apply to the Commissioner to *not* apply the non-commercial losses rules where they can satisfy the Commissioner that the nature of the business activity means that it has not met, or will not meet, the objective tests that are available to them, but based on an objective expectation, the business activity will produce assessable income greater than available deductions or meet one of the tests within a commercially viable period for the industry concerned. Any individual with an adjusted taxable income of $250,000 or more may apply to the Commissioner to *not* apply the non-commercial losses rules where they can satisfy the Commissioner, based on an objective expectation, the business activity will produce assessable income greater than available deductions within a commercially viable period for the industry concerned.	Any individual may apply to the Commissioner to *not* apply the non-commercial losses rules where they can satisfy the Commissioner that the nature of the business activity means that it has not met, or will not meet, the objective tests that are available to them, but based on an objective expectation, the business activity will produce assessable income greater than available deductions or meet one of the tests within a commercially viable period for the industry concerned.

Detailed explanation of new law

2.15 The exceptions to the general rules about non-commercial losses are aimed at providing relief for individuals where certain characteristics of the business show that it is likely to be commercial, despite having made a loss in an income year. These amendments improve the integrity, fairness and equity of the non-commercial losses rules by recognising that the current exceptions operate in a discriminatory way because high income individuals are more able to satisfy the objective tests and use these to avoid tax.

2.16 To address this issue, the new law introduces an income requirement that limits those who can access the objective tests that provide an exception to the general rule about quarantining non-commercial losses.

2.17 Division 35 creates four tests to determine whether a business activity may be treated as commercial in nature for the tax laws. The four tests are:

- the assessable income test — the assessable income generated from the activity must be at least $20,000;
- profits tests — the activity must have produced a profit in three of the last five income years;
- real property test — the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least $500,000; and
- other assets test — the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least $100,000.

Income requirement

2.18 The income requirement prevents individuals with an adjusted taxable income of $250,000 or more from accessing the existing four tests.

2.19 The income requirement is met when, in a given income year, the sum of an individual's taxable income, reportable fringe benefits, reportable superannuation contributions and total net investment losses is less than $250,000. The four amounts that make up the income requirement, when referred to together, are also known as an individual's 'adjusted taxable income'. The four amounts that make up the income requirement are defined in subsection 995-1(1). ***[Schedule 2, item 5, subsection 35-10(2D)]***

2.20 When working out if an individual has met the income requirement, the individual must disregard any excess deductions from any non-commercial business activity that has excess deductions that are subject to Division 35. ***[Schedule 2, item 5, subsection 35-10(2D)]***

2.21 Subsections 35-10(1) and (2A) are amended to allow for the introduction of the income requirement. ***[Schedule 2, items 3 and 4, paragraphs 35-10(1)(a) and (2A)(a)]***

Example 2.1

Jane received $150,000 income from her salaries and wages in 2009-10, but then a promotion increased her salaries and wages income to $250,000 for 2010-11. She also had $50,000 in reportable superannuation contributions in both years. She did not have any reportable fringe benefits or total net investment losses.

She also owns a party planning business, that mostly plans parties for her friends and family, which had an assessable income of $30,000 in 2009-10 and 2010-11, but which also had $45,000 of deductions in both years. It has never made a profit. Jane's party planning business, therefore, had excess deductions of $15,000 in 2009-10 and 2010-11. She does not apply for a discretion.

In 2009-10, Jane can apply the losses from her non-commercial business against her other income. For 2009-10, the total of Jane's salaries and wages income and her reportable superannuation contributions was $200,000, so she met the income requirement. Jane's party planning business had excess deductions, but it had an assessable income in excess of $20,000, so it met the assessable income test, so she does not have to quarantine her losses from her party planning business. For 2009-10, Jane applies the $15,000 excess losses from her party planning business against her other income.

For 2010-11, Jane cannot apply the $15,000 of losses from her party planning business attributable to the 2010-11 income year because she does not meet the income requirement. For 2010-11, the total of her salaries and wages income and her reportable superannuation contributions is $300,000, so she fails the income requirement. The $15,000 of excess deductions from 2010-11 are quarantined, and can only be applied against assessable income from her party planning business in future income years.

Applying to the Commissioner

2.22 Individuals who meet the income requirement for the most recent income year ending before the date of making the application and whose business does not meet one of the four objective tests, but who can nonetheless objectively demonstrate that their business is commercial, can apply to the Commissioner to exercise a discretion and not apply the non-commercial losses rules. That is, the existing rules continue to apply to taxpayers with an adjusted taxable income below $250,000.

2.23 Section 35-55 is amended to provide another discretion to the Commissioner for taxpayers who do not meet the income requirement for the most recent income year before the date of making the application, but who have excess deductions from a business that — based on an

objective assessment — is a commercial business. ***[Schedule 2, items 9 and 11, paragraphs 35-55(1)(b) and (c)]***

2.24 Individuals who do not meet the income requirement, but who can nonetheless objectively demonstrate that their business is commercial, can apply to the Commissioner to exercise a discretion to not apply the non-commercial losses rules.

Example 2.2

> In the 2009-10 income year, Jack has a taxable income of $200,000, reportable superannuation contributions of $50,000 and reportable fringe benefits of $20,000. Jack also owns a vineyard that is valued at $750,000. The vineyard has excess deductions of $50,000 this year.
>
> Jack does not meet the income requirement because the sum of his taxable income, reportable fringe benefits, and reportable superannuation contributions is $270,000. The vineyard has never made a profit. Despite that his non-commercial business activity is being carried on with real assets worth more than $500,000, he must now apply to the Commissioner if he wants to apply his non-commercial losses against his other income.
>
> Jack has obtained an independent assessment that the vineyard will make assessable income greater than deductions within seven years. Jack applies to the Commissioner to exercise a discretion. The Commissioner decides that there is an objective expectation, based on an independent assessment, that the vineyard will produce assessable income greater than available deductions in a given year in a period that is considered commercially viable for the industry concerned, and that Jack can apply the $50,000 against his other assessable income in this income year.

2.25 Before considering whether to exercise a discretion, the Commissioner must be satisfied that, because of its nature, the business does not or will not meet one of the four tests (only applicable for taxpayers that do not meet the income requirement) and has not produced a profit. For taxpayers with an adjusted taxable income less than $250,000, they must demonstrate that, because of its nature, the business activity does not meet any of the four of the objective tests. For individuals with an adjusted taxable income of $250,000 or more, they must demonstrate that the reason they do not or will not make a profit is because of the nature of the business and not for some other reason which is peculiar to that individual's particular business.

Example 2.3

Sergio and his bother are partners in a successful yacht building business on Sydney Harbour that makes competition yachts that are mostly used for an international race that is held every four years. Sergio does all the design, and his brother does most of the construction. Sergio is highly regarded, and has another job as a designer that pays him salaries and wages that are more than $250,000 every year.

Because the boats are only paid for when they are finished, the business, in common with other businesses of this kind, generally makes a loss for three out of every four years. Over the four year period the business makes a profit. Sergio wants to apply the losses from the business activity against his other income, and he applies to the Commissioner for a discretion.

The Commissioner decides that because of the nature of the business activity — not the manner in which Sergio and his brother run the business — it does not produce assessable income greater than available deductions in a given income year, but, that based on an objective expectation, it will produce assessable income greater than available deductions in a given income year within a timeframe that is commercially viable for the business concerned. The Commissioner exercises a discretion.

Approved form

2.26 To obtain the exercise of the Commissioner's discretion, an individual will need to complete a form approved by the Commissioner. The form will assist the Commissioner in determining whether the discretion should be exercised, by requiring the individual to provide certain information that will support the exercise of the discretion. ***[Schedule 2, item 13, subsection 35-55(3)]***

Objective evidence

2.27 The application form will require relevant information (including, where available, evidence from independent sources) to be provided by the applicant. In particular, the information required by the form may include:

- details of the nature of the business activity, including when the business activity commenced to be carried on;

- objective evidence from independent sources demonstrating that, because of the nature of the business activity, it does not or will not satisfy the tests that are available to the taxpayer, or does not produce assessable income greater than available deductions in a given income year (whichever is applicable); and

- objective evidence from independent sources that, despite the business not meeting the available test or tests, the business does not or will not satisfy the tests that are available to the taxpayer, or does not produce assessable income greater than available deductions in a given income year but will nonetheless meet the tests or produce assessable income greater than available deductions (whichever is applicable) in a period of time that is considered commercially viable for the industry concerned.

2.28 The individual is required to establish objectively the commercially viable period for the industry concerned. Evidence of what the commercially viable period for the specific industry is may include:

- current or projected information about the market for the goods or services (prices and demand) that the business activity produces;

- evidence such as industry articles, statistics, analyses and market forecasts that support the proposals or projections made in any business plan;

- evidence on the suitability of the particular business activity to the location where it is undertaken, such as soil and climate conditions, markets for the products or services and transport requirements;

- scientific research or other papers on relevant industries; and

- evidence supporting the yield and price forecasts.

2.29 The information relating to the period of time before the business can make a profit is relevant because the discretion is intended to be available where there is some inherent feature that the taxpayer's business activity has in common with other business activities of that type that prevent it from making a profit in the short term.

2.30 The taxpayer is required to establish objectively that the business is commercial in nature and will become profitable in a commercially viable timeframe. Objective evidence from independent sources can include evidence from an individual or organisation experienced in the relevant industry, such as industry or regulatory bodies, tertiary institutions, industry specialists, professional associations, government agencies or other independent entities with a similar successful business activity. Evidence from independent sources can also include evidence from business advisers (such as business plans), financiers and banks.

2.31 The Commissioner must balance the relative weight given to any evidence provided in support of an application for the exercise of a discretion. Nothing in the law requires an individual to obtain new or additional evidence about their business activity where they believe the existing evidence that is available to them demonstrates the business will meet one of the four tests (applicable for taxpayers that meet the income requirement), or produce a profit within a period of time that is commercially viable for the industry concerned. However, such additional evidence may assist the Commissioner in working out whether to exercise a discretion.

2.32 Owners of business activities that, because of their nature, have a lead time between the commencement of the activity and the production of assessable income are eligible to apply for the exercise of the Commissioner's discretion. ***[Schedule 2, item 13, note to subsection 35-55(1)]***

Exercise of the Commissioner's discretion

2.33 For taxpayers that meet the income requirement, the Commissioner may exercise a discretion after an application by a taxpayer, where the Commissioner is satisfied that the nature of the business means that, the business has not, and will not, meet the four tests, but will nonetheless — based on evidence from independent sources — meet one of the tests or produce assessable income greater than available deductions, in a timeframe that is considered commercially viable for the industry concerned.

2.34 For taxpayers that do not meet the income requirement, the Commissioner may exercise a discretion after an application by a taxpayer, where the Commissioner is satisfied that — based on evidence from independent sources — the business will produce assessable income greater than available deductions, in a timeframe that is considered commercially viable for the industry concerned.

Example 2.4

Karen carries on a business of horse breeding, training and selling horses in partnership. The partnership commenced a breeding program which will, in time, enable the breeding of high quality, sought-after animals.

It is in the nature of breeding and training horses that there will be a lead time before a profit can be expected. Independent evidence from the relevant national association supports the view that the commercially viable period for this industry, in view of the intensive training involved, would be when a horse reaches five to six years of age. This period added to the gestation period of 11 months supports a lead time of six to seven years for the industry.

Provided there is an objective expectation that the partnership business activity will make a tax profit within this commercially viable period, the Commissioner may exercise the discretion to allow losses to be claimed.

Example 2.5

Tracey carries on a business of primary production from breeding and selling cattle. Their profit projections indicate that they do not expect to make a tax profit for six years.

Independent evidence provided by Tracey indicates the lead time period begins from the commencement of the activity and includes the time taken to raise the females to a breeding age, allowing for the gestation period of those animals to finish, and finishes when the progeny have reached a saleable age. On the evidence provided, the period for a typical business activity of breeding and selling cattle to become commercially viable is no greater than three years. Therefore, Tracey will not be able to produce a tax profit within a period that is commercially viable for the industry concerned and the Commissioner will not be able to exercise the discretion to allow the losses.

2.35 The discretion is not intended to be available in cases where the failure to make a profit is for reasons other than the nature of the business, such as, a consequence of starting out small and needing to build up a client base, or business choices made by an individual that are not consistent with the ordinary or accepted practice in the industry concerned — such as the hours of operation, location, climate or soil conditions, or the level of debt funding. ***[Schedule 2, item 13, note to subsection 35-55(1)]***

Example 2.6

Joe earns in excess of $250,000 and has a substantial rural property which he and his wife visit most weekends. The property has a family residence and sheds and, apart from one area of the property where a few goats are kept, is otherwise developed with nut trees.

Joe planted a large number of nut trees on the land in 2007, and has been claiming his losses from this activity, having passed the real property test in prior years. As his income is higher than $250,000, Joe applies to the Commissioner seeking the exercise of the discretion in new paragraph 35-55(1)(c) to allow him to access his losses in 2009-10.

In support of his application, Joe provides a letter from the secretary of the Nut Tree Growers' Association that states that yields from that number and type of trees would ordinarily be sufficient to allow Joe to make a profit within about six years. This is the industry norm for growers of that type of nut tree. However, because the soil on the property is not very fertile and the site does not get a lot of sun, Joe accepts that the lead time for his particular nut-growing activity will be nine years not six years. Joe otherwise manages his nut tree orchards in accordance with industry management practices.

Having examined the case, the Commissioner concludes that, despite the large number of trees on the property and the fact that the business is being conducted in accordance with industry management practices, the discretion should not be exercised in Joe's favour. This is because the lead time for this activity to become profitable is greater than the industry norm: the failure to make a profit within a commercially viable period is due to factors that are peculiar to Joe's local environment. Despite the fact that these factors are out of Joe's control, and the fact that the activities are otherwise carried on in a commercially viable way, the excessive lead time before making a profit for Joe's activities are caused by the poor soil quality and lack of sunlight. The Commissioner does not exercise the discretion in Joe's favour because there is an excessive lead time before making a profit, when compared to other businesses in the industry.

Example 2.7

Erin is growing fruit trees in an area where such trees are not traditionally grown because of the prevailing weather conditions.

Erin's annual assessable income is greater than $250,000 so she seeks the exercise of the Commissioner's discretion under new paragraph 35-55(1)(c). In support of her application, she has discovered some international research that claims new horticultural techniques will improve the commercial viability of growing this type of fruit tree in this type of environment.

There is no general acceptance amongst Australian experts that the new techniques would make growing the trees commercially viable in Australian soils and climatic conditions. Having examined the case the Commissioner concludes that, although Erin has some evidence in the form of a technical article written by an overseas expert, that evidence does not necessarily translate to the specific conditions in Australia, and is insufficient to satisfy the objective expectation requirements of the provision. The Commissioner concludes that there is no objective expectation that the activity will make a profit within a period that is commercially viable for that industry, and declines to exercise the discretion in her favour.

Relevant income year

2.36 When the Commissioner, after an application for a discretion from a taxpayer, is working out what the taxpayer's adjusted taxable income is in order to work out if the discretion under paragraph 35-55(1)(b) or (c) should be applied, the Commissioner must look at the most recent income year that has ended immediately before the application for the exercise of a discretion by the Commissioner. ***[Schedule 2, item 9, paragraph 35-55(1)(b)]***

2.37 The Commissioner may exercise a discretion for one or more income years. ***[Schedule 2, item 7, subsection 35-55(1)]***

Application and transitional provisions

Carve-out for certain investment allowances

2.38 The *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997) is amended to not apply the non-commercial losses rules under Division 35 of the ITAA 1997 to a business activity that has greater available deductions than assessable income in a given income year only because of the investment allowances that arise because of Division 41 of the ITAA 1997; which is about the Government's small business and general business tax break.

2.39 Investment allowances for certain new business investment were introduced in 2008 to assist with stimulating economic activity. Where otherwise profitable businesses that are run by individuals or partnerships take advantage of the investment allowances, but are then placed in a tax loss position, the owners being unable to apply the losses against their other income. To remove the potentially anomalous result, the law is amended to allow the application of the losses, despite the non-commercial losses rules.

2.40 The amendment will only allow losses to be offset against other income where the loss arises *solely* because of the deduction available under Division 41 of the ITAA 1997. In all other cases the normal non-commercial losses rules will apply.

Grandfathering of existing Commissioner's discretions

2.41 To remove any doubt about whether a taxpayer that has obtained a discretion before the commencement of this Bill, the IT(TP)A 1997 is amended to allow any existing discretion to continue to apply, despite the amendments.

2.42 These changes will ensure that any discretion that has been applied by the Commissioner, including about any 'managed investment scheme' (or in any other case), will continue in effect despite the amendments.

Application

2.43 These amendments will commence from the date the Bill receives Royal Assent. ***[Clause 2]***

2.44 The amendments will apply to the 2009-10 income year and later income years. ***[Schedule 2, item 8]***

Consequential amendments

2.45 The guide to Division 35 is changed to reflect the amendment made by this Bill. ***[Schedule 2, item 5, paragraph 35-55(1)(b)]***

Chapter 3 Superannuation — Payment of lost member accounts to the Commissioner of Taxation

Outline of chapter

3.1 Schedule 3 to this Bill amends the *Superannuation (Unclaimed Money and Lost Members) Act 1999* (S(UMLM) Act) to require superannuation providers to transfer the balance of a lost member's account to the Commissioner of Taxation (Commissioner) where: the balance of the account is less than $200; or the account has been inactive for a period of five years and the provider is satisfied it will never be possible to pay an amount to the member.

Context of amendments

3.2 Part 4 of the S(UMLM) Act sets up, and the regulations establish, a scheme for dealing with lost members of funds. The scheme is intended to reduce, at an early stage, the number of accounts which become unclaimed money by reuniting members with their lost superannuation.

3.3 Under the scheme, the trustee of a superannuation fund (or a retirement savings account provider) must report details of a lost member's account to the Commissioner. The information is used by the Commissioner for the purpose of maintaining a lost members register.

3.4 Accounts that are reported to the lost members register remain with their reporting superannuation provider. Superannuation providers are also permitted to roll lost accounts over to eligible rollover funds. These accounts are in turn reported to the lost members register and remain with the eligible rollover fund concerned.

3.5 Under Part 3 of the S(UMLM) Act, amounts are paid to the Commissioner as unclaimed monies when a member reaches age 65 and cannot be found by their superannuation provider, or when a member dies and the provider cannot ensure the benefit is received by the person entitled to receive the benefit. Recent changes (to insert Part 3A) also

allow the superannuation of a former temporary resident to be paid to the Commissioner.

3.6 Accounts of less than $200 for lost members who are subsequently found can be cashed tax free from the superannuation system. However, claiming these accounts can be a cumbersome and time consuming process. Many superannuation fund members therefore do not make the effort to claim these accounts.

3.7 As at 30 June 2008, around 6.4 million lost accounts with a total value of $12.9 billion were reported on the lost members register. This represents around one per cent of superannuation assets under management. These accounts directly impact on the retirement savings of many individual Australians and also increase superannuation provider costs that may be passed on to all members.

3.8 To enhance efficiency in the superannuation system, the Government announced in the 2009-10 Budget that it will require superannuation providers to pay the small and the unidentifiable accounts of lost members to unclaimed monies, with effect from the 2010-11 financial year.

3.9 Requiring superannuation providers to pay small and unidentifiable lost superannuation accounts to unclaimed monies is one of a number of steps the Government is taking to address the growing problem of lost superannuation. This measure will also assist providers as they will no longer need to administer or apply member protection to small accounts that are transferred. This will improve equity for other members where costs are apportioned in applying the member protection rules.

3.10 Under these changes, there are no additional obligations on superannuation providers to attempt to locate lost members before the reporting and payment to the Commissioner. However, many of these accounts are unlikely to be reclaimed, as the holders are either unaware of these accounts or have not made the effort to contact their provider. In any event, individuals who have their accounts transferred to unclaimed monies will be able to reclaim these amounts directly from the Commissioner.

3.11 Former account holders reclaiming their monies are unlikely to be disadvantaged. Earnings on small accounts would generally be offset by fees and charges. In comparison, amounts held in unclaimed monies do not earn interest, and are not subject to fees and charges.

Summary of new law

3.12 Schedule 3 amends the S(UMLM) Act by inserting Part 4A. Under Part 4A, superannuation providers are required to transfer, to the Commissioner, the balances of superannuation accounts which belong to members who meet the definition of a 'lost member' at an unclaimed money day and where:

- the balance in the account is less than $200 on that day; or
- the account has been inactive for a period of five years and the superannuation provider is satisfied that it will never be possible to pay an amount to the member.

3.13 The initial transfer of lost member accounts to the Commissioner will take place during the 2010-11 financial year. Transfers will continue to be made for lost member accounts at times to be determined by the Commissioner.

Comparison of key features of new law and current law

New law	*Current law*
Superannuation providers are also required to transfer the accounts of lost members to unclaimed monies where the balance of the account is less than $200, or where the account has been inactive for a period of five years and the provider is satisfied it will never be possible to pay an amount to the member.	Amounts are paid to the Commissioner as unclaimed monies when a member reaches age 65 and cannot be found by a superannuation provider, when a member dies and the provider cannot ensure the benefit is received by the person entitled to receive the benefit, or when the account holder was identified in a section 20C notice (concerning former temporary residents).

Detailed explanation of new law

Key concepts

3.14 To distinguish between superannuation funds lost member reporting requirements under Part 4 of the S(UMLM) Act and the payment of lost member accounts to the Commissioner under Part 4A, the heading of Part 4 is amended to 'Information about lost members'. ***[Schedule 3, item 23]***

3.15 The object of Part 4A is to set out a procedure for dealing with the small accounts of lost members and inactive accounts of unidentifiable lost members. ***[Schedule 3, item 24, section 24A]***

Accounts covered by the measure

3.16 For the purposes of administering the rules in Part 4A of the S(UMLM) Act, the concept of a 'lost member account' is inserted into the definition provision at section 8 of the S(UMLM) Act. ***[Schedule 3, item 7, section 8]***

3.17 The term 'account' is defined to cover the particular arrangements that apply for retirement savings accounts ***[Schedule 3, item 6, section 8]***. The term account has its common meaning for accounts other than retirement savings accounts.

3.18 'Lost member account' means an account with a superannuation provider where the member on whose behalf the account is held is a lost member (according to the meaning already given by section 22 of the S(UMLM) Act) and:

- the balance of the account is less than $200 (small accounts); or
- the provider has not received an amount in respect of the member within the last five years and the provider is satisfied, having regard to the information reasonably available to the provider, that it will never be possible for the provider to pay an amount to the member (inactive accounts of unidentifiable members).

[Schedule 3, item 24, section 24B]

3.19 Accounts belonging to a lost member that support or relate to a defined benefit interest (as defined by section 292-175 of the *Income Tax Assessment Act 1997* (ITAA 1997)) are excluded from the measure. ***[Schedule 3, item 24, paragraph 24B(1)(c)]***

Example 3.1

A member is reported on the lost members register and no amounts have been received in respect of the member within the last five years. The only identifiable record held by a superannuation provider in respect of the member is the member's name (that is, it does not have other member details such as address, date of birth, employer information or tax file numbers (TFNs)). Even if the member were to subsequently contact the fund and provide valid proof of identity documentation, the provider — on the basis of the meagre information

available from its records — could not be satisfied that the individual is the person on whose behalf the account was opened. The account is not a defined benefit interest. The account is an inactive account of an unidentifiable member and is therefore a lost member account.

Example 3.2

A superannuation provider has an account, that is not a defined benefit interest, for which it is satisfied it will never be able to make a payment to the member due to the sparse information available. The member has not made personal, or received employer contributions, to the account for more than five years; however, earnings have been credited to the account. The account is still a lost member account as it satisfies the definition of an 'inactive account of an unidentifiable member'.

Unclaimed money

3.20 The simplified outline of the S(UMLM) Act is being amended to reflect the amendments being made to that Act by Schedule 3. ***[Schedule 3, items 1 to 5, paragraphs 6(a), (ca), (e) and 6(ea) and section 7]***

3.21 The definitions of 'non-member spouse', 'payment split', and 'splittable payment' are removed from subsections 12(3) and 13(1B) of the S(UMLM) Act and consolidated into section 8. The definitions continue to have the same meanings as in Part VIIIB of the *Family Law Act 1975*. ***[Schedule 3, items 8, 9, 11 and 13, section 8, subsections 12(3) and 13(1B)]***

3.22 The definition of 'scheduled statement day' is amended to include a statement required by Part 4A of the S(UMLM) Act. ***[Schedule 3, item 10, section 8]***

3.23 A minor technical amendment replaces references in the S(UMLM) Act of 'for at least 2 years' with 'within the last 2 years' to provide consistent terminology in the Act. ***[Schedule 3, items 12 and 14, paragraphs 12(1)(c) and 14(c)]***

Dates for statements and payments of lost member accounts

3.24 For the purposes of the S(UMLM) Act, the Commissioner is able to specify unclaimed money days by legislative instrument. The Commissioner may also specify the scheduled statement day that relates to the unclaimed money day by legislative instrument. These days, as specified by the Commissioner, will apply for the purposes of Part 4A. ***[Schedule 3, items 15 and 16, paragraphs 15A(a) and (b)]***

Statement of lost member accounts

3.25 A superannuation provider is required, by section 24C of the S(UMLM) Act, to give to the Commissioner, by the end of the scheduled statement day that relates to an unclaimed money day, a statement in relation to all lost member accounts as at the end of the unclaimed money day.

3.26 The Commissioner may, under the *Taxation Administration Act 1953* (TAA 1953), defer the time for the superannuation provider to give the statement of unclaimed money. If the information is not given by the required time, the TAA 1953 provides for offences and administrative penalties. ***[Schedule 3, item 24, subsections 24C(1) and (5)]***

3.27 This requirement under section 24C does not apply to a superannuation provider which is the trustee of a state or territory public sector superannuation scheme as defined in subsection 18(7) of the S(UMLM) Act and which gives a statement to a state or territory authority as provided for in section 18. ***[Schedule 3, item 24, subsection 24C(1) and section 24H]***

3.28 A statement under section 24C will be required to be given in a form approved by the Commissioner. The statement can contain information required by the Commissioner in respect of lost member account administration, and require certain TFNs as provided for by subsection 25(4).

3.29 Such reporting may include information that allows the Commissioner to apply the correct taxation treatment to a payment of unclaimed money made in respect of a person under section 24G of the S(UMLM) Act.

3.30 If the statement required to be given by a superannuation provider under subsection 24C(1) includes false or misleading statements, the TAA 1953 provides for offences and administrative penalties. This will make the penalties for lost member accounts consistent with broader taxation administration. ***[Schedule 3, item 24, subsection 24C(1)]***

3.31 Where a statement is required by subsection 24C(1) and there are no lost member accounts for any member (or holder in the case of a retirement savings account provider) at the end of the unclaimed money day, the statement must say so. ***[Schedule 3, item 24, subsection 24C(2)]***

3.32 The requirement for a superannuation provider to give a statement under section 24C does not apply to a regulated superannuation fund with fewer than five members if there are no lost member accounts at the end of the unclaimed money day in that fund. That is, small

Australian Prudential Regulation Authority regulated superannuation funds will only be required to give to the Commissioner such a statement if they have lost member accounts at the end of an unclaimed money day. ***[Schedule 3, item 24, subsection 24C(4)]***

3.33 The statement of lost member accounts required to be given by a superannuation provider under subsection 24C(1) to the Commissioner will include information about any account that, between the end of the unclaimed money day and the day on which the superannuation provider gives the statement to the Commissioner, ceases to be a lost member account because the member ceases to be a lost member. ***[Schedule 3, item 24, subsection 24C(3)]***

Example 3.3

> On 30 June 2010 Lidia's superannuation provider considered the amount payable to Lidia was a lost member account as it satisfied all the conditions of subsection 24B(1) of the S(UMLM) Act. The amount was due and payable before 1 October 2010. However on 31 July 2010 Lidia made a contribution to her account, resulting in the criterion of paragraph 24B(1) no longer being satisfied.
>
> Although the amount payable to Lidia was no longer a lost member account, Lidia's superannuation provider is still required to include, in the statement of lost member accounts, information in relation to the account.

3.34 Superannuation providers are not required to give a statement to the Commissioner under section 24C where the amounts payable relate to unclaimed money or certain former temporary residents for which the Commissioner has given notice to the superannuation provider under section 20C. ***[Schedule 3, item 24, subsection 24C(6)]***

Example 3.4

> Nadia was a former temporary resident who last left Australia in 2005. On 30 June 2010 Nadia's superannuation provider considered the amount payable to Nadia was unclaimed money and a lost member account as it satisfied all the conditions of subsections 12(1) and 24B(1) of the S(UMLM) Act. The amount was due and payable on 1 October 2010 under subsections 17(1) and 24E(1) of that Act. However on 1 August 2010 the Commissioner gave a notice (former temporary resident notice) to Nadia's superannuation provider under section 20C of the S(UMLM) Act. As a result Nadia's superannuation provider was required to pay an amount to the Commissioner in accordance with section 20F of that Act and no longer required to pay the amount under subsection 17(1) or 24E(1). That is, the priority for statements and payments to the Commissioner for amounts payable under the S(UMLM) Act will be:

1. Payment of unclaimed superannuation of former temporary residents.

2. Payment of unclaimed money.

3. Payment of lost member accounts.

Errors or omissions

3.35 Where a superannuation provider is required to give the Commissioner a statement under section 24C of the S(UMLM) Act and the provider becomes aware of a material error in, or omission from, that statement, the provider must give the Commissioner the corrected or omitted information in the approved form no later than 30 days after becoming aware of the error or omission.

3.36 These provisions provide greater certainty to the Commissioner that superannuation providers have correctly fulfilled their reporting obligations under the S(UMLM) Act.

3.37 A superannuation provider's obligations to correct an error or omission remain even if the Commissioner becomes aware of the error or omission, including where the Commissioner takes action as a result of such a discovery (for example, by refunding under section 24J of the S(UMLM) Act an overpayment made by a superannuation provider).

3.38 The Commissioner may, under section 388-55 in Schedule 1 to the TAA 1953, defer the time for the superannuation provider to give the information. If the information is not given by the required time, the TAA 1953 provides for offences and administrative penalties. The operation of penalties for lost member accounts is consistent with broader taxation administration. ***[Schedule 3, item 24, section 24D]***

Payment of lost member accounts to the Commissioner

3.39 A superannuation provider must, under subsection 24E(1) of the S(UMLM) Act, pay to the Commissioner the amount worked out under subsection 24E(3), in respect of an account that is a lost member account at the end of the unclaimed money day and the member on whose behalf the account is held is still a lost member as at the time (the calculation time), immediately before the earlier of the time (if any) the payment is made and the time at which the payment is due and payable.

Example 3.5

The balance of a lost member's account in a fund on the unclaimed money day is $195. Therefore it is an account that must be paid to the Commissioner. Between the unclaimed money day and the scheduled statement day the fund credits the account with earnings of $6, bringing the balance to $201.

However as the value of the account was still below $200 on the unclaimed money day — the account must still be paid to the Commissioner even though its balance is now greater than $200.

Example 3.6

Continuing from Example 3.3, Lidia's superannuation provider is not required to pay an amount to the Commissioner under subsection 24E(1) of the S(UMLM) Act on 1 October 2010 in relation to Lidia, as the lost member account in question ceased to be a lost member account between the end of the unclaimed money day and the day on which the superannuation provider gives the statement of unclaimed money to the Commissioner.

3.40 The amount the provider must pay the Commissioner is due and payable at the end of the scheduled statement day for the relevant unclaimed money day.

3.41 The Commissioner may, under section 255-10 in Schedule 1 to the TAA 1953, defer the time at which the amount is due and payable by the superannuation provider. The amount the provider must pay is a tax-related liability for the purposes of the TAA 1953 and as such a general interest charge and administrative penalties are connected with such liabilities. The amendments in this Bill make penalties operate for lost member accounts consistent with broader taxation administration. ***[Schedule 3, item 24, subsection 24E(1)]***

3.42 Section 24J of the S(UMLM) Act allows the Commissioner to refund an overpayment by the provider. ***[Section 3, item 24, subsection 24J(1)]***

3.43 The requirements of subsection 24E(1) do not apply to a superannuation provider which is a trustee of a state or territory public sector superannuation scheme which gives a statement and makes a payment to a state or territory authority as provided for in section 18 of the S(UMLM) Act. ***[Schedule 3, item 24, subsection 24E(1) and section 24H]***

3.44 The amount due and payable under subsection 24E(1) of the S(UMLM) Act is the amount that would have been due and payable by the superannuation provider if the lost member had requested that the balance be rolled over to a complying superannuation fund (within the meaning of the *Superannuation Industry (Supervisory) Act 1993*). Thus

the amount payable would be determined after the application of returns and exit fees to the account. ***[Schedule 3, item 24, subsections 24E(2) and (3)]***

Example 3.7

> A superannuation provider would normally credit earnings to an account and debit an exit fee if the member's account was rolled over to a complying superannuation fund. The amount payable to the Commissioner is the balance of the account after the earnings are credited and the exit fee is debited.

3.45 The amount of a payment must only take account of the person's entitlement to payment remaining after any reduction by a payment split under Part VIIIB of the *Family Law Act 1975* (disregarding subsection 90MB(3) of that Act). ***[Schedule 3, item 24, paragraph 24E(4)(a)]***

3.46 The superannuation provider must also pay an amount to the Commissioner in respect of the non-member spouse, equivalent to the amount of the reduction applied to the lost member's entitlement. ***[Schedule 3, item 24, paragraphs 24E(4)(b), (c) and (d)]***

3.47 Subsection 24E(1) does not require the superannuation provider to pay the Commissioner an amount that satisfied the conditions outlined in subsection 24B of the S(UMLM) Act if the amount relates to either unclaimed money or a person for whom the Commissioner has given notice to the provider under section 20C of that Act. This is because unclaimed money is payable under section 17 of that Act and the unclaimed money of former temporary residents is payable to the Commissioner under section 20F of that Act. ***[Schedule 3, item 24, subsection 24E(5)]***

3.48 Superannuation providers are discharged from further liability for amounts paid under section 24E. ***[Schedule 3, item 24, subsection 24E(6)]***

3.49 Accounts with nil balances or below nil balances as at the end of the calculation day can be ignored. That is, if the amount to be paid to the Commissioner is nil or below nil then no amount is payable to the Commissioner in respect of the lost member account. ***[Schedule 3, item 24, subsection 24E (7)]***

3.50 A superannuation provider is liable to pay a general interest charge on the amount in respect of lost member accounts that is due and payable under section 24E and remains unpaid after it is due and payable. ***[Schedule 3, item 24, subsection 24F(1)]***

3.51 The S(UMLM) Act provides that an offence is committed if a person by their conduct breaches a requirement under section 24E. ***[Schedule 3, item 24, subsection 24F(2)]***

Payment by the Commissioner in respect of a person for whom an amount has been paid to the Commissioner

3.52 The Commissioner must pay an amount in respect of a person if a superannuation provider paid an amount to the Commissioner under subsection 24E(1) of the S(UMLM) Act in respect of that person and the Commissioner is satisfied that an amount can be paid in respect of that person under subsection 24G(2) of that Act. The Commissioner may either be satisfied on receipt of an application in the approved form or by the Commissioner's own initiative. ***[Schedule 3, item 24, subsection 24G(1)]***

3.53 Money for payments under subsection 24G(2) of the S(UMLM) Act is appropriated by section 16 of the TAA 1953.

3.54 If the Commissioner can pay an amount, in respect of a person who is still alive, because the conditions in subsection 24G(1) are satisfied, then the Commissioner must pay the amount to the person if the person has reached eligibility age or the amount is less than $200, unless the person directs the Commissioner to pay the amount to a fund that is a complying superannuation plan. In the case of payments to a fund, the Commissioner can only pay to a single fund. ***[Schedule 3, item 24, paragraphs 24G(2)(a) and (d)]***

Example 3.8

If the Commissioner has received an amount of $150 from Fund A and $190 from Fund B, the Commissioner can pay each amount directly to the person as each amount is less than $200. This is the case even if the person is younger than the eligibility age of 65.

3.55 If, after the death of the person, the Commissioner can pay an amount in respect of a person because the conditions in subsection 24G(1) are satisfied and the Commissioner is satisfied that the superannuation provider, had it not paid the amount to the Commissioner, would have been required to pay a death benefit amount or amounts to one or more death beneficiaries as a result of the person's death, then the Commissioner must pay the amount to that beneficiary or beneficiaries. If the Commissioner cannot be so satisfied, the Commissioner must pay the amount to the person's legal personal representative. ***[Schedule 3, item 24, paragraphs 24G(2)(b) and (c)]***

Example 3.9

A lost member account in respect of Andrew was paid to the Commissioner by the superannuation provider under subsection 24E(1) of the S(UMLM) Act. At that time the superannuation provider also provided details about the binding death benefit nomination that Andrew had which nominated his wife Thea as the death beneficiary.

After Andrew died, Thea contacted the Australian Taxation Office to inquire about lost or unclaimed superannuation held for her deceased husband either in a fund or by the Commissioner. The Commissioner was able to be satisfied through documents provided by Thea that Andrew's superannuation provider would have been required to pay Thea a death benefit had it not paid an amount in respect of Andrew to the Commissioner as a lost member account. As the relevant conditions of paragraph 24G(2)(b) of the S(UMLM) Act apply, the Commissioner must make a payment to Thea in accordance with subsection 24G(3) of that Act.

3.56 A formula is applied to death beneficiary payment cases covered by paragraph 24G(2)(b). If there is only one death beneficiary the whole of the amount is payable to that beneficiary. However where there is more than one death beneficiary the formula acts as a proportioning rule to determine how much of the amount the Commissioner has available to pay, is payable to each death beneficiary. ***[Schedule 3, item 24, subsection 24G(3)]***

3.57 Section 24G does not apply to an amount that is to be, or has been, taken into account in determining whether the Commissioner must make a payment under section 20H. ***[Schedule 3, item 24, subsection 24G(4)]***

Refunds, overpayments and returns

3.58 Similar to the conditions in section 20K of the S(UMLM) Act, where an amount is to be refunded by the Commissioner under section 24J, the Commissioner must pay the relevant amount to the superannuation provider which made the underlying overpayment (or, if that superannuation provider no longer exists, to the provider of a successor fund). ***[Schedule 3, item 24, subsection 24J(2)]***

3.59 Money for payments under subsection 24J(2) of the S(UMLM) Act is appropriated by section 16 of the TAA 1953.

3.60 Section 24K of the S(UMLM) Act allows the Commissioner to recover an overpayment that results from a payment made, or purportedly made, under Part 4A in respect of a person in a similar manner as provided for by section 20L for an overpayment made under Part 3A (that is, payment of unclaimed money of former temporary residents). ***[Schedule 3, item 24, section 24K]***

3.61 Before recovering an overpayment the Commissioner must give the debtor a written notice about the proposed recovery and specify the amount to be recovered. Prescribing the details to be covered by the written notice gives the Commissioner flexibility to alter the notice to allow for changing circumstances. ***[Schedule 3, item 24, paragraph 24K(4)(a)]***

3.62 The notice in section 24K is not a 'legislative instrument' within the definition in section 5 of the *Legislative Instruments Act 2003* because it does not have a legislative character which determines or alters the content of the law; it is merely declaratory of the law and causes the law to be applied. ***[Schedule 3, item 24, subsection 24K(8)]***

3.63 The S(UMLM) Act provides that if a superannuation provider cannot credit a payment made by the Commissioner under subsection 24G(2) within a certain period to an account for the benefit of the person, then the superannuation provider must return the payment to the Commissioner. This is similar to section 20M of the S(UMLM) Act in relation to payments made by the Commissioner under Part 3A (that is, payment of unclaimed money of former temporary residents).

3.64 The amount the provider must pay is a tax-related liability for the purposes of the TAA 1953 and the Commissioner can deal with the amount in a way that is consistent with broader taxation administration, including deferring the time that the amount is due and payable and applying a general interest charge and administrative penalties in connection with such liabilities. ***[Schedule 3, item 24, section 24L]***

Administrative matters

Unclaimed and lost member registers

3.65 The register of unclaimed money will now also contain particulars of the lost member accounts paid to the Commissioner under section 24E of the S(UMLM) Act. ***[Schedule 3, item 17, paragraphs 19(1)(e) and (f)]***

3.66 Other minor cross referencing amendments are made to section 20H of the S(UMLM) Act. ***[Schedule 3, items 18 to 22, section 20H]***

Information, access and records

3.67 Schedule 3 amends section 25 of the S(UMLM) Act to allow the TFN of the superannuation provider, the fund, and a member of the fund to be provided to the Commissioner for the purposes of section 24C. ***[Schedule 3, item 25, subsection 25(4)]***

3.68 Section 29 of the S(UMLM) Act is amended to allow the Commissioner to request the TFN of a person making an application for an amount which has been paid to the Commissioner under subsection 24G(1). ***[Schedule 3, item 26, paragraph 29(1)(aa)]***

Taxation administration

3.69 Consequential amendments are made to the TAA 1953 so that a superannuation provider is liable to pay a general interest charge on an amount in respect of a lost member account that is due and payable under sections 24F and 24L of the S(UMLM) Act and remains unpaid after it is due and payable. This amendment will make the operation of the lost member account provisions in respect of payments to the Commissioner consistent with unclaimed money and broader taxation administration. ***[Schedule 3, item 41, subsection 8AAB(5) of the TAA 1953]***

3.70 Consequential amendments are made to subsection 250-10(2) of the TAA 1953 so that an amount a superannuation provider must pay under section 24E or 24L of the S(UMLM) Act is a tax-related liability for the purposes of administrative penalties and offences that need to be connected with such liabilities. The amendments make the operation of the penalties and offences for the lost member accounts paid to the Commissioner consistent with unclaimed money and broader taxation administration. A minor technical correction is also made to subsection 250-10(2) of the TAA 1953. ***[Schedule 3, items 42 and 43, subsection 250-10(2) in Schedule 1 to the TAA 1953]***

Financial transaction reports

3.71 Under the *Financial Transaction Reports Act 1988* if a cash dealer does not have certain information about an account, the account is blocked and withdrawals from such an account can give rise to an offence under that Act. However, this does not apply to certain withdrawals made in accordance with the S(UMLM) Act, including the payment of lost member accounts to the Commissioner. The *Financial Transaction Reports Act 1988* is amended to reflect Part 4A of the S(UMLM) Act. ***[Schedule 3, item 27, paragraph 18(4B)(ca) of the Financial Transaction Reports Act 1988]***

Compensation arrangements

3.72 If the operation of these amendments would result in an acquisition of property from a person otherwise than on just terms, and the Commonwealth and the person cannot agree on the amount of the compensation, the person may institute proceedings in a court of competent jurisdiction for the recovery from the Commonwealth of such reasonable amount of compensation as the court determines. ***[Schedule 3, item 24, section 24M]***

Income tax amendments

3.73 Consequential amendments are made to the ITAA 1997 to ensure payments made by the Commissioner under section 24G of the S(UMLM) Act in respect of a person for whom an amount has been paid to the Commissioner under section 24E of the S(UMLM) Act will be treated and taxed as if they were paid from a complying superannuation fund. ***[Schedule 3, items 28 to 40, section 301-125, subsections 307-5(1), 307-142(1) to (3), 307-300(1) to (3), 307-350(2B), and paragraph 307-120(2)(e) of the ITAA 1997]***

Application and saving provisions

3.74 The amendments made by Schedule 3 apply in relation to the last unclaimed money day occurring before 1 July 2010 and later unclaimed money days. ***[Schedule 3, item 44]***

3.75 If, before the commencement of Schedule 3, regulations made for the purposes of paragraph 18B(4)(a) of the S(UMLM) Act were in force, the regulations have effect, from that commencement, as if they had also been made for the purposes of paragraph 24K(4)(a) of that Act, as inserted by Schedule 3. These regulations deal with written notices from the Commissioner to debtors. ***[Schedule 3, item 45]***

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