Baker McKenzie.

Client Alert

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Australia: Treasury introduces exposure draft legislation for simplified tax treatment and easing of securities law restrictions for share-based awards

Updates on new tax and securities legislation

In this issue

In brief

Following the Government's announcement in this year's Federal Budget, the Treasury has released exposure draft legislation to implement changes to regulatory and tax arrangements for employee share schemes (ESS). The exposure draft legislation is largely consistent with this year's Federal Budget announcement (discussed in our June 2021 client alert). These reforms aim to make it easier for businesses to offer ESS and to support Australian businesses to attract and retain talent.

The Government is conducting a consultation process in relation to the exposure draft legislation and we have made submissions to Treasury on the draft legislation.

Key takeaways

Although we still do not have any guidance as to when the measures will be introduced into Parliament, the exposure draft legislation provides greater detail as to the proposed regulatory and tax changes.

If implemented, the proposals would result in:

- the removal of the cessation of employment taxing point for share-based awards granted to employees
- broader securities law exemptions, enabling both listed and unlisted entities to make ESS offers without needing to prepare a prospectus or hold an Australian financial services licence (AFSL) – however, the draft legislation contains some new unfortunate restrictions for options granted by listed companies (as further detailed below)

Removal of cessation of employment as a taxing point

As anticipated, the draft tax reforms propose to remove cessation of employment as a taxing point for ESS interests which are subject to deferred taxation. If an employee ceases employment their deferred taxation arrangement will continue until the earlier of:

- In the case of awards of shares (e.g., restricted shares) – when there is no risk of forfeiture and no restrictions on disposal
- In the case of rights to acquire shares (e.g., restricted stock units (RSUs) or options) – when the employee exercises the option or the RSU vests and there is no risk of forfeiting the resulting share and no restriction on disposal
- Fifteen years from the grant date

If the shares are sold within 30 days after the relevant time set out in the first two bullet points, the taxing point will be moved to the date of sale.

The exposure draft materials do not give any guidance as to how the change will impact on ESS reporting. There seems to be no change to the current requirement that providers of ESS interests will need to report taxing events that occur after an employee has ceased employment. If a number of years has passed between the cessation of employment and the taxing point, this may present practical challenges.

It is important to note that, as the removal of the cessation of employment as a taxing point will only apply to awards granted on or after the next 1 July following Royal Assent, it will be some time before terminated employees see any benefit. The measure will not apply to awards granted prior to 1 July of the year the change comes into effect. We are hoping the amending legislation will receive Royal Assent prior to 1 July 2022, but there is no guarantee.

In our submission to Treasury we made the points that:

- We welcome the removal of cessation of employment as a taxing point
- Cessation of employment should cease to be a taxing point for all outstanding awards rather than for new grants from the date the rules come into effect
- To keep cessation of employment as a taxing point for outstanding awards, but not new grants encourages excessive tax planning and administrative confusion
- There should be administrative concessions for ESS reporting where an employee is unable to contact an ex-employee

Easing of securities law restrictions

The exposure draft legislation also implements changes to the way in which ESS offers are regulated under the Corporations Act 2001 (Cth) (CA).

As matters currently stand, the key exemptions for ESS offers are contained in ASIC Class Orders 14/1000 and 14/1001. These exemptions enable entities to make ESS offers without needing to prepare a prospectus (or similar document) or hold an AFSL.

The conditions in Class Order 14/1000 are typically easy to satisfy, and the exemption has proved a popular way for listed entities, both Australian and foreign, to operate employee equity plans in Australia. In contrast, Class Order 14/1001, which applies to unlisted entities, contains a number of restrictive conditions which have made it much less easy to use. In particular, Class Order 14/1001 can only be used where the total value of awards granted to any one employee in any 12-month period is no more than AUD 5,000.

In broad terms, the proposed changes involve replacing the two Class Orders with analogous exemptions in the CA. The exposure draft legislation departs from the Class Orders in a number of ways which will likely make it more attractive at least to unlisted companies, but introduces some unfortunate new restrictions for options granted by listed companies. We believe these restrictions may be drafting errors, but this remains to be seen.

The new rules at a glance

The key features of the proposed new rules are as follows:

- Offers by listed or unlisted companies that are restricted to employees and that do not require payment of money can be made without any prescribed form of disclosure and without the need for an AFSL.
- Offers that require monetary payment, or that are extended to independent contractors as well as employees, will also be conditionally exempt from the prospectus and AFSL requirements. A "notice of intent" will need to be filed with ASIC, and issuing companies will need to provide employees with an "ESS offer document". Unlisted companies making such offers must also comply with a "value cap" of AUD 30,000.
- Offers of options by listed companies are only covered by — and are therefore only exempt under — the new rules if the options are listed (which almost certainly will not be the case) or if the options have been granted with a zero exercise price.
- Offers that require monetary payment must comply with an "issue cap" (5% for listed companies and 20% for unlisted companies).
- The existing statutory exemptions (such as the senior manager and the 20-in-12 exemptions for grants of options or other securities) will remain available for offers that are not covered by the new rules. For offers covered by the new rules, these

exemptions will not be directly available, but there are carve-outs designed to ensure that offers that would otherwise have been exempt under existing legislation continue to be treated in the same way.

How do the new rules compare to the Class Orders?

Points of similarity

Many features of the exposure draft legislation are similar to the existing Class Order exemptions. For example:

- The new regime will generally cover the same types of awards — including, shares, options, RSUs and stapled securities (in the case of listed entities) and ordinary shares, options and RSUs (in the case of unlisted companies).
- The new regime, like the Class Orders, covers offers to employees, directors, independent contractors and prospective employees and directors.
- The requirements for a "notice of intent" and an "ESS offer document" are broadly similar to the "notice of reliance" and "offer document" requirements under the current Class Orders.
- The "issue cap" and (in the case of unlisted companies) the "value cap" operate in a similar way to the issue caps under the Class Orders and the AUD 5,000 value cap under Class Order 14/1001 (although see the next section).

Points of difference — the good...

However, there are also some important differences. In particular:

- Under the new regime, listed and unlisted entities alike will be able to make free grants to employees without having to meet any specific disclosure obligations. This is a significant improvement, because it means that unlisted companies can now make free grants without being limited to the AUD 5,000 value cap.
- Entities don't need to be quoted on a major stock exchange for three months in order to be treated as "listed" for the purposes of the new rules. This contrasts with Class Order 14/1000, which is only available to entities that have been listed (without interruption) for at least three months.
- Unlisted companies that want to grant awards requiring a monetary payment will be subject to a value cap. However, the cap has been increased from AUD 5,000 to AUD 30,000. Based on our experience, this will be welcome news for many unlisted companies that hitherto have not been able to utilise the exemption in Class Order 14/1001.
- Even where the AUD 30,000 value cap applies, there are some carve-outs, including for senior managers. This means that unlisted companies will be able to make awards of any value to senior managers, regardless of whether those awards require monetary payment.
- Subject to meeting certain requirements, under the new rules unlisted companies will be able to operate share purchase plans and loan plans. Again, this is in contrast to Class Order 14/1001, which specifically precludes these possibilities.

...the bad

Whilst these differences are likely to make the new exemptions more attractive and easy to use, especially for unlisted companies, it is not all good news. Under the proposed new rules:

- Listed entities cannot grant options or RSUs unless the options or RSUs are publicly traded (which almost certainly will not be the case) or they have both a zero grant price **and** a zero exercise price. This is a significant limitation, since in effect it means that options can only be granted with a zero exercise price.
- Unlisted companies that have to provide an "ESS offer document" will also need to give employees a copy of their most recent accounts, being accounts that they are otherwise required to file with ASIC or (if they don't file accounts with ASIC) a balance sheet and profit and loss statement prepared in compliance with Australian accounting standards. This may present difficulties for foreign companies that are not required to file accounts in Australia, since:
  - They may regard their accounts as commercially sensitive and be unwilling to disclose them to employees
  - The requirement to prepare accounts under Australian accounting standards may prove onerous
- If an unlisted company has to provide an "ESS offer document" and its business has an annual turnover of more than AUD 50 million, it must also give employees an independent valuation of the awards at the time of grant and (if the awards have an exercise price) of the underlying shares at the time of exercise.

...and the ugly

The new rules also include a liability regime under which:

- ASIC can issue stop orders in relation to defective ESS disclosure documents
- A person who issues a misleading or deceptive ESS disclosure document can face both civil and criminal liability

Whilst this liability regime is broadly equivalent to the prospectus liability regime that already exists under the CA, it is significant because it is targeted specifically towards ESS offers. If this liability regime is passed into law, among other things it will:

- Impose a positive duty on companies to ensure that their ESS disclosure documents remain up-to-date
- Potentially make directors liable for any contravention by their company
- Impose potentially very significant penalties both for substantive breaches (such as where an ESS offer is misleading) and more technical breaches (such as a failure to file a "notice of intent")

The exposure draft legislation also contains what appear to be a number of drafting anomalies or inconsistences. In our submission to Treasury, we have highlighted what we believe to be the key drafting anomalies, as well as the key substantive shortcomings, of the new rules.

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