1. **Introduction**

The purpose of this paper is to examine the scope of the amendments to the Australian taxation of employee shares/options for inbound and outbound employees which are contained in the *New International Tax Arrangements (Foreign Owned Branches and Other Measures) Bill 2005* that was introduced into the House of Representatives on 17 March 2005. These amendments are part of the Government's response to the Board of Taxation's report on international tax (*RITA*).

The general effect of these amendments is to amend the income tax laws to more closely align the Australian taxation of employees shares/options with international norms developed by the OECD. The amendments are relevant for individuals who work in more than one country or who change their country of residence.

As a general guide only, the amendments are likely to:

(a) result in less Australian tax payable by employees who have an Australian connection at the time of grant (i.e., who are either resident on grant, or, if non-resident, are working in Australia at the time of grant) but who also perform services outside Australia to which the grant of the shares/options relate. In particular, the changes are likely to be most beneficial for Australian resident employees who are working overseas at the time of grant of shares/options; but

(b) result in more Australian tax payable by employees who are non-resident at the time of grant of employee shares/options, but who later perform services in Australia to which the grant of the shares/options relate. This category of people can include foreign employees who are transferred to Australia after the grant of the shares/options, but also ‘Australian employees’ who are granted shares/options while working overseas as non-residents who then return to Australia with unvested shares/options.

The amendments generally apply to employee shares/options granted after the date the Act receives Royal Assent. Importantly, however, the amendments will also apply to any person who has been granted shares/options before that date if that person was not working in Australia at the time of Royal Assent, but then later comes to work in Australia before the relevant shares/options have vested. This means that the amendments could have potential adverse implications for ‘Australian’ employees who are currently working as non-residents overseas. That is, employees returning to Australia after the date of Royal Assent, but before the vesting of any shares/options that were granted to them while a non-resident, will now be subject to tax under Division 13A on those shares/options (notwithstanding those shares/options will have been granted before the date of Royal Assent). This is a different Australian tax outcome to what those employees may have been told at the time of grant of those shares/options, so care should be taken to ensure that such employees are advised of this Australian tax law change before their return to Australia.
2. Overview of Current Law

2.1 Division 13A

Taxpayers who receive shares/options at less than market value in relation to employment or services are taxed on those shares/options under Division 13A. The taxing time is generally on grant, unless those shares or rights are 'qualifying'. If the shares/rights are 'qualifying' the taxpayer has a choice to elect to be taxed on grant, or to defer the taxing time.

The two major issues with the current operation of Division 13A as it relates to the cross border taxation of employee shares/options are the deferral condition that the shares/options be in the 'employer' and the lack of any sourcing rules.

(a) 'Employer' requirement

One of the conditions for employee shares/options to be 'qualifying' (and therefore entitled to defer the taxing time) is that those shares/options are in the employer company, or the holding company of the employer. 'Employer' for these purposes is defined by reference to someone who is paying the recipient salary that is subject to Australian tax.

This requirement is generally unable to be satisfied where the recipient of the shares/rights is working offshore at the time of grant. This is because, in the case of a non-resident working offshore at the time of grant, Australia generally has no right to tax the salary as there is no relevant Australian source. In the case of a resident working offshore at the time of grant, section 23AG generally applies to exempt the salary from Australian tax. As the relevant salary is not subject to Australian tax, these 'workers' are not entitled to defer the Division 13A taxing time on the grant of employee shares/options.

This is generally considered a bad outcome for residents working offshore at the time of grant of employee shares/options, but a good outcome for non-residents working offshore at the time of grant of the shares/options for the following reasons.

(i) Residents working off-shore on grant

Residents working offshore at the time of grant of employee shares/options, who are exempt from Australian tax on their offshore salary under section 23AG, are subject to Australian tax at the time those shares/options are granted even though, had they been working onshore, they would have been entitled to a choice as to whether to pay tax on grant or to defer.

(ii) Non-residents working offshore on grant

Non-residents working offshore at the time of grant of employee shares/options are prima facie subject to Australian tax at the time of grant of those shares/options. However where, at that time, there has been no relevant Australian employment, the generally accepted position has been that no Australian tax is payable under Division 13A (eg see ATO ID 2003/190), notwithstanding that the non-resident may later commence working in Australia prior to the vesting of the shares/options.
This category of people can include foreign employees who are later transferred to Australia after the grant of shares/options, but also 'Australian employees' who are granted shares/options while working overseas as non-residents who then return to Australia with unvested shares/options.

(b) Lack of sourcing rules

Division 13A contains no 'sourcing' rules to reduce the Division 13A taxable amount by reference to offshore employment.

For example, assume a resident working in Australia was granted options with a 3 year vesting period, of which 2 of those years were spent as a non-resident working for the overseas parent company, before returning to Australia and exercising the options. Arguably the full amount of the gain made on exercise of the options would be taxable under Division 13A, notwithstanding that 2/3rds of the vesting period was spent working overseas. As the employee will be a resident at the relevant taxing time, the likely double tax remedy in such circumstances would be a claim for a foreign tax credit for tax payable in the foreign jurisdiction in relation to the options. If however the employee were a non-resident at the relevant taxing time, then it should be possible to reduce the 'Australian' sourced amount of the taxable gain by the vesting period worked off-shore especially if the employee is resident in a treaty country.

2.2 CGT treatment on ceasing/becoming an Australian resident

(a) Ceasing to be an Australian resident

If an employee ceases to be an Australian resident, they are deemed for CGT purposes to have disposed of their employee shares/options (unless they elect to continue to have those assets subject to CGT, or are entitled to the temporary residents exemption), notwithstanding that the employee may not yet have had a Division 13A taxing time on those shares/options.

(b) Becoming an Australian resident

If an employee becomes an Australian resident while holding employee shares/options, the employee is generally deemed for CGT purposes to have a cost base of those shares/options equal to the market value at the time of becoming a resident.

2.3 Section 23AG

Section 23AG exempts Australian residents from tax in respect of certain 'foreign earnings' (eg salary). 'Foreign earnings' for these purposes do not currently include employee shares/options that are taxed under Division 13A.

2.4 Double Tax Agreements

Article 15 of most of Australia's DTA's (dependant personal services article) provides that Australia's right to tax salary, wages and other similar remuneration of a resident of the relevant treaty country is limited to such remuneration as is derived from the exercise of employment in Australia.
In June 2004 the OECD published its final report titled ‘Cross Border Income Tax Issues Arising from Employee Stock Option Plans’, which included changes to the Commentary of the OECD Model Tax Convention on how to deal with the relevant issues. That report concluded the following.

(a) Any benefit accruing in relation to stock options up to the time when they are exercised, sold, or otherwise alienated should be treated as income from employment to which Article 15 applies.

(b) All relevant facts and circumstances will need to be taken into account to determine to which services the grant of options relate. As a general rule, options should not be considered to relate to any services rendered after the vesting period for the options, nor to services rendered before the grant of the options. In cases of doubt, it should be recognised that options are generally provided as an incentive for future performance or as a way to retain valuable employees and therefore are primarily related to future service.

The net effect of this OECD approach is that the rights to tax the gain made on the exercise of options will generally be allocated between countries based on the proportion of the vesting period spent working in that country. For example, assume an employee is working in Australia when he receives a grant of 1,000 options exercisable at the then market price of $1, with a 3 year vesting period, and a 10 year life. The employee then becomes a non-resident on transfer to an overseas subsidiary company at the end of year 2 (assume market value of shares at that time is still $1), and exercises the options in year 6, while still a non-resident, when market value of the shares is $4. The gain on exercise would be $3,000 of which Australia would have a source country taxing right for $2,000 being 2/3rds of the total gain on exercise. That is, the gain is calculated by reference to the period to exercise, but the right to tax is allocated by reference to the period worked during vesting. The ‘mismatch’ of the longer period over which the gain is calculated compared with the shorter period over which that gain is sourced can result in ‘odd’ revenue sourcing outcomes, especially if there is a reasonable time lag between vesting and exercise.

3. **Overview of Proposed Changes**

3.1 **New non-resident source rule in Division 13A**

New section 139B(1A) provides that, for any period during which the employee is a non-resident, the Division 13A amount is not included in income to the extent that it relates to the employee's engagement in foreign service.

The proposed operative date for these changes are any shares/options granted after the date the Act receives Royal Assent, and any person who has been granted shares/options before the date of Royal Assent if that person was not working in Australia at the time of Royal Assent, but then later comes to work in Australia. Importantly (and unfairly) however the amendments will not apply to shares/options granted before Royal Assent to an employee working in Australia who later works offshore as a non-resident. In those circumstances, the old regime of DTA relief if non-resident at taxing time, or foreign tax credits if resident at taxing time is likely to continue to apply.
What this source amendment means is that when an employee (resident or non-resident) has a Division 13A taxing time on employee shares/options, the taxable amount will be reduced to the extent that it ‘relates to’ foreign service as a non-resident.

While Division 13A does not go on to prescribe how to calculate that part of the taxable gain that relates to foreign service as a non-resident, it is clear from the EM that the intention is to apply the OECD approach to sourcing the gain. Clearly the actual service period to which shares/options will be treated as relating to will be very heavily dependant of the particular plan rules and HR policies. The EM indicates that whether or not forfeiture conditions continue to apply is likely to be of significance. There is some discussion in the OECD commentary about the difference between a delay in the period that something can be exercised/sold (ie a blocking period) and a period of service that is required to obtain a vested interest in the share/option. It would generally be considered that, if shares/options are vested but continue to be subject to a holding lock period, that should not be sufficient to indicate that the blocking period should be relevant in allocating sourcing rights.

For example, assume an employee is resident in Australia on grant of options that have a 3 year vesting period, becomes a non-resident at the end of year 1, returns to Australia at the end of year 3 and exercises the options in year 6. As 2 of the 3 year vesting period of the options would have been spent working offshore as a non-resident, it would be expected that 2/3rds of the Division 13A taxable gain would not be included in income under this new sourcing rule.

This 2/3rds approach would apply whether or not the employee elected to pay tax on the grant of the options, or deferred the taxing time (although the taxable amounts would be likely to differ). In the event that the employee elected to pay tax on the grant of the options based on an estimate of a vesting period in Australia other than 1/3 (more or less), the employee/ATO would be able to amend the tax return for the year in which the options were granted for up to 4 years from the end of the year in which the options vested (new section 139DG). The EM indicates that, as a general proposition, employees should assume the remainder of any vesting period will be spent working in Australia (and amend later if that proves to not be correct) unless there is reasonable evidence to the contrary (eg employee comes to Australia on 1 year contract).

3.2 New rules for residents working offshore

(a) Resident employees working offshore at time of grant to qualify for Division 13A deferral

The Division 13A definitions of ‘employer’ and ‘employee’ will be amended to include persons engaged in foreign service at the time of grant. This means that resident employees working offshore who are granted shares/options will generally be entitled to defer the Australian taxing time on those shares/options. This is a significant improvement over the current tax treatment for such people.

However if the employee did not start work in Australia before the cessation time for the shares/options (eg options granted and exercised while resident but offshore), the Division 13A taxing time would remain on grant of the options. While it is likely in these circumstances that the full Division 13A taxable amount would be
exempt from tax under the new section 23AG (refer (c) below), the impact on the rate of tax for 'other income' would be by reference to the year of grant, not the later time of returning to Australia or the cessation time. As this eventuality may not be known at the time of grant of the shares/options, it may require an amendment to the tax return in the year of grant of the options.

(b) **Resident employees working offshore at time of grant to be given choice to pay tax on returning to Australia, or continuing to defer until cessation time.**

A resident employee working offshore at the time of grant of shares/options will be able to elect to be subject to tax on previously granted shares/options in the year of returning to Australia, or to continue to defer tax until cessation time (assuming the shares/options are qualifying).

In the event an employee elects to be taxed on shares/options granted in years prior to the returning year, the taxable value will be calculated as the value at grant, not the time of returning to Australia. Such an election would apply to all employee shares/options granted while offshore which have not yet vested at the time of returning (but would not include any granted in the year of return).

(c) **Resident 'foreign earnings' exemption to extend to Division 13A income**

The definition of 'foreign earnings' in section 23AG(7) is to be amended to cover amounts included in a person's assessable income under Division 13A. This means that if an employee is an Australian resident at the Division 13A taxing time, the Division 13A taxable amount may be reduced to the extent that it relates to services provided offshore (provided the employee has been engaged in continuous foreign service for at least 91 days and the amount is not exempt from tax in the foreign jurisdiction as a result of treaty relief etc). This is a significant improvement over the current tax treatment for such people.

If the Division 13A taxing time is prior to knowing how much of the vesting period will be offshore (e.g., if an employee working in Australia elects to be taxed on grant of the options, but then is later unexpectedly transferred offshore before vesting), the employee/ATO would be able to amend the tax return for the taxing year for up to 4 years from the end of the year in which the shares/options vested (new section 139DG).

This new exemption will generally only be relevant for services provided offshore while a resident as any service provided offshore while a non-resident would not be taxable under Division 13A as a result of the new non-resident sourcing rule (refer 3.1). This means that the part of the gain on employee shares/options that relates to working as a non-resident will not impact the rate of tax payable on other income notwithstanding the employee is a resident at the relevant taxing time.

While the section 23AG amendments do not prescribe how to calculate that part of the taxable gain that relates to foreign service, it is clear from the EM that the intention is to apply the OECD approach to sourcing the gain (refer discussion at 3.1).
(d) **Proposed operative dates**

The proposed operative date for the above amendments are:

(i) any shares/options granted after the date the Act receives Royal Assent; and

(ii) any person who has been granted shares/options before the date of Royal Assent if that person was not working in Australia at the time of Royal Assent, but then later comes to work in Australia.

The amendments will not however apply to shares/options granted before Royal Assent to a resident working in Australia who later works offshore during the vesting period.

3.3 **Division 13A extended to apply to non-residents commencing Australian employment while holding unvested shares/options**

Division 13A will impose a taxing time on non-residents when they first commence Australian employment if, at that time, they are holding unvested employee shares/options (section 139B(2A)). This category of people can include foreign employees who are transferred to Australia after the grant of the shares/options, but also 'Australian employees' who are granted shares/options while working overseas as non-residents who then return to Australia with unvested shares/options. Importantly the proposed application date for these amendments will include any person who has been granted shares/options before the date of Royal Assent if that person was not working in Australia at the time of Royal Assent, but then later comes to work in Australia.

While Division 13A is being extended to apply to non-residents commencing Australian employment while holding unvested shares/options, such employees will then generally be given a choice to either elect to pay tax in the year of commencing work in Australia, or to defer tax until the cessation time. Further, the taxable amount will of course be reduced under rule 3.1 by that part of the vesting period worked off-shore.

(a) **Paying tax in year of commencing work in Australia**

Tax could be payable in the year of commencing employment in Australia, either because the relevant shares/options are not qualifying or because the employee makes an election to be taxed in that year on all unvested shares/options held at the time of commencing work in Australia (but excluding shares/options granted in that year). A separate election could be made in relation to shares/options granted in the year of commencing work in Australia.

Importantly, the taxable value will be calculated as the value at grant, not the time of commencing in Australia.

Note that, pursuant to the amendment to the definition of ‘employer’ and ‘employee’ outlined at 3.2(a) above, options/shares may be qualifying at the time of coming to work in Australia notwithstanding the employee was not an 'Australian' employee at the time of grant of the shares/options. However, in the case of shares, there is the additional hurdle for deferral of the 75% offer test. Assume an offshore employer who does not have any direct 'Australian' employees, operates a global
executive employee share plan where the relevant shares are subject to forfeiture and disposal restrictions. A non-resident employee then comes to work in Australia for a subsidiary of the off-shore employer at a time when the shares are still subject to forfeiture conditions. As the offshore employer did not have any ‘Australian’ employees at the time the employee shares were granted to the non-resident, it is arguable that the 75% offer test is not applicable (eg see ATO ID 2003/24). This approach could result in the potentially ‘odd’ outcome that Australian executives of the subsidiary who may have participated in the same plan would not have been entitled to the deferral concession, but the non-resident who later came to work in Australia would. While this outcome may appear odd, the fact that the 75% offer test applies on a stand alone employer basis, rather than a group basis, necessarily means that odd outcomes can result, even in a totally on-shore context.

If the employee is required, or chooses, to pay tax in the year of coming to Australia, and it is later determined that the estimate of the vesting period relevant to Australia was incorrect, the employee/ATO would be able to amend the tax assessment for the year of coming to Australia for up to 4 years from the end of the year in which the shares/options vested (new section 139DG).

(b) **Defer tax until cessation time**

If the employee chose to defer tax until the cessation time, the Division 13A taxable amount would then be reduced by reference to the vesting period spent offshore (refer 3.1).

3.4 **CGT and Division 13A interactions on ceasing and becoming Australian resident**

(a) Any capital gain or loss on ceasing to be an Australian resident will be disregarded if Division 13A deferral still applies.

(b) CGT cost base on becoming Australian resident:

(i) if choosing later Division 13A taxing time – market value at Division 13A time;

(ii) if Division 13A on becoming resident - remains market value at that time (rather than Division 13A taxable amount which is calculated by reference to value at grant).

These amendments will apply to employees becoming residents on or after the date of Royal Assent.

3.5 **Other related amendments**

(a) **FBT**

The FBT exemption for contributions to employee share trusts will be extended to allow the activities of such trusts to include holding and providing shares to non-Australian employees of the relevant employer company.
(b) **FIF**

Section 530A of the FIF rules will be amended to make it clear that there will be no deemed FIF income where an employee is deferring the taxing time under Division 13A for the whole of the relevant FIF year. This amendment will apply to income years ending after the date of Royal Assent.

4. **Inbound option example**

4.1 **Facts**

- Joe is non-resident employee of Global Bank who has been granted 1,000 options on 1 January of each year since 2003.
- The options have an exercise price equal to market value on grant, a 3 year cliff vesting period and a maximum 10 year life.
- On 1 April 2006 Joe is transferred to the Australian office of Global Bank for a 2 year assignment. Joe continues to receive his annual grant of options while in Australia.
- Joe returns offshore on 1 April 2008, works for Global Bank until 1 January 2010 when he exercises all of his then vested options (when value of shares is $17) and then leaves Global Bank.

4.2 **Calculation of Australian taxable amounts (In Australia 1 April 2006 to 1 April 2008)**

<table>
<thead>
<tr>
<th>Grant Date</th>
<th>Vest Date</th>
<th>Number of options</th>
<th>Exercise price</th>
<th>Gain on exercise</th>
<th>Australian proportion (vesting months)</th>
<th>Estimate of Australian taxable amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 03</td>
<td>Jan 06</td>
<td>1,000</td>
<td>10</td>
<td>7,000</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Jan 04</td>
<td>Jan 07</td>
<td>1,000</td>
<td>11</td>
<td>6,000</td>
<td>9/36</td>
<td>506**</td>
</tr>
<tr>
<td>Jan 05</td>
<td>Jan 08</td>
<td>1,000</td>
<td>12</td>
<td>5,000</td>
<td>21/36</td>
<td>1,288**</td>
</tr>
<tr>
<td>Jan 06</td>
<td>Jan 09</td>
<td>1,000</td>
<td>13</td>
<td>4,000</td>
<td>24/36</td>
<td>1,595***</td>
</tr>
<tr>
<td>Jan 07</td>
<td>Jan 10</td>
<td>1,000</td>
<td>14</td>
<td>3,000</td>
<td>15/36</td>
<td>1,073</td>
</tr>
<tr>
<td>Jan 08</td>
<td>Jan 11</td>
<td>1,000</td>
<td>15</td>
<td>0</td>
<td>3/36</td>
<td>230****</td>
</tr>
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<td>Jan 12</td>
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<td>16</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

* Assumes Australian taxable value on grant (before reduction) of 18.4% of exercise price.

** Covered by one election (ie can not elect for one year and not other), and included in tax return for year commenced in Australia (year ended 30 June 2006). Based on value at grant.

*** Covered by separate election as grant year same as year of commencing in Australia (even though granted prior to coming to Australia). Such an election would also cover other employee shares/right granted in that year.

**** Refund can be requested on lapse of options.
5. Comparison of Outcomes under Old and New Law – Resident on Grant of Shares/Options

5.1 Example Calculations

At the beginning of year 1 Joe is granted 1,000 options with an exercise price of $1 per option, a 3 year vesting period and a 10 year life. Joe remains working for the same company group until he exercises the options at year 6 and immediately sells the shares for $4 per share, resulting in a gain to Joe of $3,000 (1,000 options x ($4 - $1)).

5.2 Joe is resident (and working in Australia) on grant, but is non-resident on exercise

Joe's employment is transferred to the overseas parent company at the end of year 2 and he does not return to work in Australia.

(a) Division 13A outcomes under current law

If Joe did not elect to be taxed on grant of options, Joe will prima facie be taxed on $3,000 on exercise of the options. However, if Joe is a resident of a treaty country at that time, the taxable gain on exercise is likely to be reduced under the DTA to $2,000 (as Joe worked in Australia for 2 of the 3 vesting years).

If Joe elected to be taxed on grant of the options (while a resident), the market value on grant would be taxable. However, if Joe was later required to pay foreign taxes on exercise of the options, it should be possible to amend the tax return for the year the options were granted to claim a foreign tax credit.

(b) Division 13A outcomes under proposed law

If Joe did not elect to be taxed on grant of options, Joe will be taxed on $2,000 on exercise of the options. This is because the Division 13A taxable gain on exercise would be reduced under new section 139B(1A) – refer 3.1.

If Joe elected to be taxed on grant of the options, the Division 13A amount would be limited to 2/3rds of the relevant market value at that time (although the full amount might be included with a later amendment if it was not clear at the time of lodgement of the return that Joe would be leaving Australia at the end of year 2).

(c) Comparisons

Similar outcomes if up-front tax not elected. New law likely to be better outcome if up-front tax elected.

5.3 Joe is resident (but working overseas) on grant, and is non-resident on exercise

Joe works overseas (but remains a resident) until the end of year 1, comes back and works in Australia until the end of year 2 and then his employment is transferred to the overseas parent company at the end of year 2 (and he does not return to work in Australia).

(a) Division 13A outcomes under current law

As Joe is working overseas on grant of the options, the options will not be 'qualifying'. This means that Joe will be subject to tax on the grant of the options. Joe should be entitled to claim foreign tax credits for tax he may be required to pay
in the country he was working on grant of the options, and in the country he later becomes a resident of.

(b) **Division 13A outcomes under proposed law**

Joe will be entitled to elect to pay tax on the options when he returns to Australia at the end of year 1 (by reference to value on grant, and reduced to 1/3).

If Joe chooses to defer tax, he will be taxed on $1,000 on exercise.

(c) **Comparisons**

Likely to be a better outcome under new law.

5.4 **Joe is resident on grant and exercise, but worked overseas after grant.**

Joe’s employment is transferred to the overseas parent company at the end of year 1 and he returns to work in Australia at the end of year 3 and remains in Australia until exercise of the options.

(a) **Division 13A outcomes under current law**

If Joe did not elect to be taxed on grant of options, Joe will prima facie be taxed on $3,000 on exercise of the options. Joe should be entitled to claim foreign tax credits for tax he is required to pay in the country he was working in for 2/3rds of the vesting period.

If Joe elected to be taxed on grant of the options the market value of the options on grant will be taxable. However, if foreign taxes are later paid, it should be possible to amend the tax return to claim foreign tax credits.

(b) **Division 13A outcomes under proposed law**

If Joe did not elect to be taxed on grant of options, Joe will be taxed on $1,000 under Division 13A on exercise of the options. This is because the Division 13A taxable gain on exercise would be reduced under the proposed amendments to section 23AG.

If Joe elected to be taxed on grant of the options the Division 13A amount would be limited to 1/3rd of the relevant market value at that time.

(c) **Comparisons**

Likely to be a better outcome under new law.

5.5 **Joe is resident on grant and exercise, but working overseas at time of grant**

Joe works overseas (but remains a resident) until the end of year 1, comes back and works in Australia until exercise of the options.

(a) **Division 13A outcomes under current law**

As Joe is working overseas on grant of the options, the options will not be 'qualifying'. This means that Joe will be subject to tax on the grant of the options. Joe should be entitled to claim foreign tax credits for tax paid in the country he was working on grant of the options.
(b) **Division 13A outcomes under proposed law**

Joe will be entitled to elect to pay tax on the options when he returns to Australia at the end of year 1 (by reference to value on grant, and reduced to 2/3rds under s.23AG). If Joe chooses to defer tax, he will be taxed on $2,000 on exercise.

(c) **Comparisons**

Likely to be a better outcome under new law.

### 5.6 Resident on grant: Comparison of tax relief for ‘foreign sourced’ Division 13A income

<table>
<thead>
<tr>
<th>Work location on grant</th>
<th>Residency on exercise</th>
<th>Tax relief under old law</th>
<th>Tax relief under new law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Overseas</td>
<td>(a) No election: reduction</td>
<td>Reduction</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(b) Election: FTC</td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>Australia</td>
<td>FTC</td>
<td>Reduction</td>
</tr>
<tr>
<td>Overseas*</td>
<td>Overseas</td>
<td>FTC</td>
<td>Reduction</td>
</tr>
<tr>
<td>Overseas*</td>
<td>Australia</td>
<td>FTC</td>
<td>Reduction</td>
</tr>
</tbody>
</table>

* Resident but working overseas on grant. Therefore, under old law, no deferral of taxing time under Division 13A as shares not qualifying on grant as not in ‘employer’.

### 6. Comparison of Outcomes under Old and New Law – Non-resident on Grant of Shares/Options

6.1 **Example Calculations**

At the beginning of year 1 Joe is granted 1,000 options with an exercise price of $1 per option, a 3 year vesting period and a 10 year life. Joe remains working for the same company group until he exercises the options at year 6 and immediately sells the shares for $4 per share, resulting in a gain to Joe of $3,000.

6.2 **Joe is non-resident (but working in Australia) on grant, and resident on exercise**

Joe works in Australia until the end of year 1 (but is non-resident), is transferred back overseas until the end of year 3 when he is sent back to Australia and becomes an Australian resident until the time the options are exercise.

(a) **Division 13A outcomes under current law**

If Joe did not elect to be taxed on grant of options, Joe will prima facie be taxed on $3,000 on exercise of the options. Joe should be entitled to claim foreign tax credits for tax paid in the country he was resident in for 2/3rds of the vesting period.

If Joe elected to be taxed on grant of the options the market value of the options on grant would be taxable, but would be subject to reduction to 1/3 under the relevant DTA.
(b) Division 13A outcomes under proposed law

If Joe did not elect to be taxed on grant of options, Joe will be taxed on $1,000 on exercise of the options. This is because the Division 13A taxable gain on exercise would be reduced under new section 139B(1A).

If Joe elected to be taxed on grant of the options, the Division 13A amount would be limited to 1/3rd of the relevant market value at that time.

(c) Comparisons

 Likely to be a better outcome under new law.

6.3 Joe is non-resident (and working overseas) on grant, but is resident on exercise

Joe works overseas (as a non-resident) to the end of year 1, and then comes and works in Australia (as a resident) until his options are exercised.

(a) Division 13A outcomes under current law

As Joe is working overseas on grant of the options, the options will not be 'qualifying’. However as Joe is also a non-resident, there is arguably no Australian sourced Division 13A income as, at the time of grant, no services will have been provided in Australia.

(b) Division 13A outcomes under proposed law

Joe will be entitled to elect to pay tax on the options when he comes to Australia at the end of year 1 (by reference to value on grant, and reduced to 2/3rds under s139B(1A) in relation to the 1 year as a non-resident). If Joe chooses to defer tax, he will be taxed on $2,000 on exercise.

(c) Comparisons

 Likely to be a worse outcome under new law.

6.4 Joe is non-resident on grant and exercise but working in Australia on grant

Joe works in Australia (as non-resident) until the end of year 1, and is transferred back overseas where he remains until the options are exercised.

(a) Division 13A outcomes under current law

If Joe did not elect to be taxed on grant of options, Joe will prima facie be taxed on $3,000 under Division 13A on exercise of the options. However if Joe is a resident of a treaty country, the Division 13A taxable gain on exercise is likely to be reduced under the DTA to $1,000, representing 1 of the 3 vesting years worked in Australia.

If Joe elected to be taxed on grant of the options, the market value on grant would be taxable, but would be subject to reduction to 1/3 under the relevant DTA.

(b) Division 13A outcomes under proposed law

If Joe did not elect to be taxed on grant of options, Joe will be taxed on $1,000 under Division 13A on exercise of the options. This is because the Division 13A taxable gain on exercise would be reduced under new section 139B(1A).
If Joe elected to be taxed on grant of the options the Division 13A amount would be limited to 1/3rd of the relevant market value at that time.

(c) **Comparisons**

Likely to be similar outcomes under both (assuming treaty country).

6.5 **Joe is non-resident (and working overseas) on grant and exercise, but working in Australian in between**

Joe works overseas (as a non-resident) to the end of year 1, and then comes and works in Australia until the end of year 2 and then returns overseas until exercise of the options.

(a) **Division 13A outcomes under current law**

As Joe is working overseas on grant of the options, the options will not be 'qualifying'. However as Joe is also a non-resident, there is arguably no Australian sourced Division 13A income as, at the time of grant, no services will have been provided in Australia.

(b) **Division 13A outcomes under proposed law**

Joe will be entitled to elect to pay tax on the options when he comes to Australia at the end of year 1 (by reference to value on grant, and reduced to 1/3 under s139B(1A) in relation to the 1 year as a non-resident). If Joe chooses to defer tax, he will be taxed on $1,000 on exercise.

(c) **Comparisons**

Likely to be worse outcome under new law.

6.6 **Non-resident on grant - Comparison of tax relief for ‘foreign sourced’ Division 13A income**

<table>
<thead>
<tr>
<th>Work location on grant</th>
<th>Residency on exercise</th>
<th>Tax relief under old law</th>
<th>Tax relief under new law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Australia</td>
<td>(a) No election: FTC</td>
<td>Reduction</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(b) Election: Reduction</td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>Overseas</td>
<td>Reduction</td>
<td>Reduction</td>
</tr>
<tr>
<td>Overseas</td>
<td>Australia</td>
<td>Division 13A N/A*</td>
<td>Reduction</td>
</tr>
<tr>
<td>Overseas</td>
<td>Overseas</td>
<td>Division 13A N/A*</td>
<td>Reduction</td>
</tr>
</tbody>
</table>

* Non-resident and working overseas on grant. Therefore, under old law, Division 13A applied on grant, but arguably no Australian sourced amount.

7. **Conclusions**

7.1 **Non-residents who are granted shares/options while working overseas**

Employees who have been working offshore (either as residents or non-residents) who come to work in Australia on or after the date the Bill receives Royal Assent may potentially be subject to tax under Division 13A. In the case of non-residents, this is a change to the
previously accepted tax treatment. This means that, employees returning to Australia after
the date of Royal Assent, but before the vesting of any shares/options that were granted to
them while a non-resident, will now be subject to tax under Division 13A on those
shares/options (notwithstanding those shares/options will have been granted before the
date of Royal Assent). This is a different Australian tax outcome to what those employees
may have been told at the time of grant of those shares/options, so care should be taken to
guarantee that such employees are advised of this Australian tax law change before their
return to Australia.

Employee coming to work in Australia after the date of Royal Assent will be required to do
the following.

(a) Determine, at the time of coming to Australia, what employee shares/rights they
are holding that could potentially be seen as relating to their forthcoming service
period in Australia. This will require careful consideration of the terms of the
relevant plan rules under which those shares/rights were acquired.

(b) In the event that some or all of the shares/rights may be seen as relating to service
in Australia:

(i) determine if those shares/rights are likely to be ‘qualifying’ (and therefore
entitled to deferral of the Australian taxing time). In the case of shares, it is
not clear whether the 75% offer test will be relevant in the event that the
offshore employer company did not have any Australian employees at the
time the shares were granted, so further clarification may be required on
this issue;

(ii) in the case of qualifying shares/rights, make a decision as to whether an
election should be made to pay tax on those shares/rights in the year of
coming to Australia. In order to make such a decision, it is likely that a
Division 13A valuation of those shares/rights at the date of grant will be
required; and

(iii) if tax is to be paid on the unvested shares/rights in the year of coming to
Australia, make a reasonable estimate of what proportion of the relevant
vesting period will relate to services to be provided in Australia (this can be
amended later if it proves to be inaccurate).

7.2 Residents on grant of shares/options who work offshore

Employees working in Australia who are granted shares/rights after the date the Bill
receives Royal Assent should take into account the potential reduction of their Division 13A
taxable amounts, having regard to any proposal to work offshore during the relevant
vesting period. In particular, if such an employee were considering electing to pay tax on
the grant of the shares/rights, it might be reasonable to reduce the taxable amount, having
regard to expected future offshore service during the vesting period. As with inbound
employees, the relevant service period over which particular shares/rights can be said to
relate will require careful consideration of the terms of the relevant plan rules under which
those shares/rights were acquired.