
C Taxation

C.1 Taxation of equity-based payments

Australian taxation arrangements

Equity-based payments are remuneration for employment services provided in the form of equity or rights (this could constitute shares or options). Commonly, receipt of these payments is determined by the fulfilment of performance hurdles and the existence of ‘holding locks’ (where an employee cannot dispose of the share or right until a fixed period of time has elapsed). Given that a significant proportion of executive pay is provided in the form of equity or rights, taxation arrangements for this form of income are particularly relevant when examining issues of executive remuneration.

Equity-based payments attract both income tax and capital gains tax (CGT) (on sale of equity). Taxation of equity-based payments can be complex as:

- different amounts may be taxed as salary or substitutes for salary, fringe benefits, or capital gains
- there are several points in time at which tax can be applied
- the ‘value’ of equity can be difficult to determine where the rights provided are subject to vesting requirements or contingencies, particularly for non-traded equities (such as executive stock options) .

Often concessionary tax treatment is provided for equity-based payments issued through employee share schemes that promote broader employee share ownership. The extent to which executives can benefit from these concessions can vary.

Taxation of equity-based payments from employee share schemes

In Australia, if a taxpayer acquires a share or right as employment income, the assessable income of the taxpayer includes the difference between the market value of the share or right on the day that tax is paid and the amount paid to receive the share or right (this value is called the ‘discount’). A share or right must be provided

at a ‘discount’ to fall under the employee share scheme legislation. While a ‘right’ is not explicitly defined in the legislation it is generally taken to mean an option.

Prior to July 2009, employees who received shares or options under ‘qualifying’ employee share or option plans (box C.1) were able to elect either to:

- defer when the discount from shares or options was assessable as taxable income
- pay income tax upfront and receive a \$1000 tax exemption (division 13A, *Income Tax Assessment Act 1936* (Cwlth) (ITAA 1936)).

Table C.1 provides a comparison of the new and old approaches.

In the 2009-10 budget, changes were announced to the taxation of equity received through employee share schemes (proposed division 83A, *Income Tax Assessment Act 1997* (Cwlth) (ITAA 1997)). Under the new legislation, equity received through employee share plans will be taxed on acquisition unless one of the following circumstances apply:

- Equity is at ‘real risk of forfeiture’ — and where particular conditions are fulfilled (box C.1), tax can be deferred for up to 7 years or until the point where the risk of forfeiture is removed and no genuine restrictions preventing disposal of the share exist, or where employment is terminated (whichever occurs first). The taxing point for rights is based on similar principles, with some additional conditions to account for situations specific to rights (for example, where they are exercised) (box C.2).
- Approved salary sacrifice employee share scheme — where no more than \$5000 worth of shares are offered to each employee in an income year (with no risk of forfeiture). The scheme must meet the requirements for a qualifying scheme (box C.1), have a minimum holding period of 3 years or at cessation of employment, and be clearly distinguished from schemes which qualify employees for the upfront \$1000 deduction.

In addition, access to the tax exemption of \$1000 for tax paid upfront is limited to taxpayers with an adjusted taxable income of less than \$180 000 (House of Representatives 2009).

Table C.1 Comparison of key features of new law and current law

<i>New Law</i>	<i>Current Law</i>
<p>Upfront taxation is the default position. Deferral of tax will be limited to schemes which:</p> <ul style="list-style-type: none"> • 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 \$5000 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. <p>Eligibility for the upfront or deferred tax concession is based on the characteristics of the employee share scheme.</p> <p>Employees with a taxable income (after adjustments) of less than \$180 000 will receive the upfront concession and not pay tax on the first \$1000 of discounts received, if the scheme meets certain conditions.</p> <p>In schemes where the tax is deferred, the taxing point is the earliest of:</p> <ul style="list-style-type: none"> • 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. <p>An employee is eligible for a refund of tax on forfeited shares and rights if the forfeiture was not the result of:</p> <ul style="list-style-type: none"> • 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. <p>Employers are subject to annual reporting requirements.</p> <p>A limited form of withholding tax applies in cases where an employee fails to provide their employer with a tax file number or ABN at the taxing point.</p>	<p>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.</p> <p>An employee may elect between the upfront or deferred tax concession if they acquire 'qualifying' shares or rights.</p> <p>Employees in a qualifying scheme can elect to be taxed upfront and not pay tax on the first \$1000 of discounts received. There is no means testing.</p> <p>Where an employee has chosen to defer tax, the taxing point is the earliest of:</p> <ul style="list-style-type: none"> • 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. <p>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.</p> <p>No equivalent.</p> <p>No equivalent.</p>

Source: House of Representatives (2009).

Box C.1 ‘Qualifying’ conditions to defer taxation on equity-based payments

Under division 83A, ITAA 1997, tax can be deferred on a share where all seven conditions below are satisfied; tax can be deferred on a right to acquire a share where all the conditions below are satisfied, excepting the fourth condition. These conditions have the same effect as the ‘qualifying conditions’ applied under division 13A, ITAA 1936 (s. 139CD).

1. The share or right is acquired by a taxpayer at a discount under an employee share scheme.
2. When the taxpayer acquires the share or right they are employed by the company or a subsidiary of the company.
3. All the shares available for acquisition under the scheme are ordinary shares and all the rights available for acquisition under the scheme are rights to acquire ordinary shares.
4. The scheme must be non-discriminatory: that is at least 75 per cent of the permanent employees who have completed at least three years of service and are Australian residents are, or at some earlier time had been, entitled to acquire equity under an employee share scheme or equity in the employer or a holding company of the employer through another employee share scheme.
5. Unless the prominent business of the company is the acquisition, sale or holding of shares, securities or other investments and the taxpayer is employed by the company and also employed by another company that is a subsidiary, holding company or subsidiary of a holding company of the first company.
6. Immediately after the acquisition of the share or right, the taxpayer does not hold a legal or beneficial interest in more than 5 per cent of the shares in the company.
7. Immediately after the acquisition of the share or right, the taxpayer is not in a position to cast, or control the casting of, more than 5 per cent of the maximum number of votes that might be cast at a general meeting of the company. (House of Representatives 2009).

Deferral of tax and real risk of forfeiture

Under the new arrangements, ‘risk of forfeiture’ is a precondition to defer tax. Under the legislation a ‘real risk of forfeiture’ includes meaningful performance hurdles or a requirement to serve a minimum term of employment.

A share or right under an employee share scheme is at real risk of forfeiture where:

- 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

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- 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. (House of Representatives 2009, p. 35)

The Explanatory Materials also note that a share or right is not at ‘real risk’ where a reasonable person would disregard this ‘risk’ as highly unlikely to occur, or as nothing more than a rare eventuality or possibility. Thus, contrived schemes where the ‘risk’ is highly unlikely to arise will not qualify for tax deferral.

A restriction that prevents an employee from disposing of a share or right for a specified period of time does not constitute a ‘real risk of forfeiture’, and thus does not enable deferral of income taxation by itself. However, where other conditions are present that pose a real risk of forfeiture, holding restrictions can enable deferral of tax beyond the point where the real risk of forfeiture is lifted.

In this context, ‘genuine restrictions’ can include conditions of the employee share scheme that contractually prohibit disposal of shares, an internal company policy with serious and enforced consequences for breaches, or where disposal of the equity is a criminal offence (for example, where disposal would infringe insider trading laws).

Box C.2 Taxation point for rights under risk of forfeiture

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 [the] 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. (House of Representatives 2009, pp. 48–9)

Approved salary sacrifice employee share scheme

The new legislation also allows for deferral of taxation where equity is provided through an eligible salary sacrifice scheme. Equity-based payments made through eligible schemes must be in shares and not rights and the salary sacrifice arrangement must be part of the employee's remuneration package — it must be reasonable to conclude that the salary or wages would be greater were the shares not part of that package.

However, both shares and rights are able to be offered where they are at risk of forfeiture (a 'matching scheme'). This ensures that employers are able to provide schemes with equity acquired both under salary sacrifice arrangements and at real risk of forfeiture.

The total market value of the shares acquired through an approved salary sacrifice scheme in any income tax year must not exceed \$5000 (calculated by the market value of the shares at the time they are acquired). However, this limit only applies to equity acquired through salary sacrifice and does not apply to other equity acquired through the scheme that is at risk of forfeiture.

Where tax on equity provided through an employee share scheme is deferred under salary sacrifice arrangements the same taxing point as that applicable to tax on equity at risk of forfeiture applies.

Taxation of non-qualifying equity

A share or right must be offered at a discount to fall under division 83A, ITAA 1997 (or under division 13A, ITAA 1936 under the previous arrangements). Where a share or right is not offered to an employee at a discount, income tax is not payable.

Where a share or right is offered at a discount, and thus falls under division 83A, but does not qualify for concessional treatment (for example, because it does not meet the qualifying conditions (box C.1) or does not have a real risk of forfeiture), the discount is included in the taxpayer's assessable income in the year of income in which the share or right is acquired and no tax exemption is available.

International taxation arrangements

In most OECD countries, equity-based payments are generally treated as ordinary employment income and taxed at income tax rates with CGT payable on sale of the asset. However, it is common for countries to offer concessional taxation treatment

for employee equity schemes that meet particular requirements. The requirements and the type of concessions offered can vary significantly by jurisdiction. Concessionary schemes may provide for equity-based payments to be taxed at capital gains rates and not as employment income (as is the case in the examples above), permit a deferral of income tax or provide a tax exemption. For example, in Poland (for all schemes) and Denmark, the United Kingdom, Ireland and the United States (for concessionary schemes only) — employee options are taxed only as capital gains and not employment income (OECD 2005).

It should also be noted that, there are generally four points in time where taxation of equity-based payments may occur: at grant, at vesting (once restrictions on the option or share are removed), at exercise (for options) and at sale. Removal of the ‘risk of forfeiture’ is used as a taxing point in other jurisdictions, for example, both the United States and United Kingdom. However, it is not always defined in the same way as in Australia. For example, in the United States, Securities and Exchange Commission restrictions on insider trading are considered a ‘substantial risk of forfeiture’ (Schulman 2002).

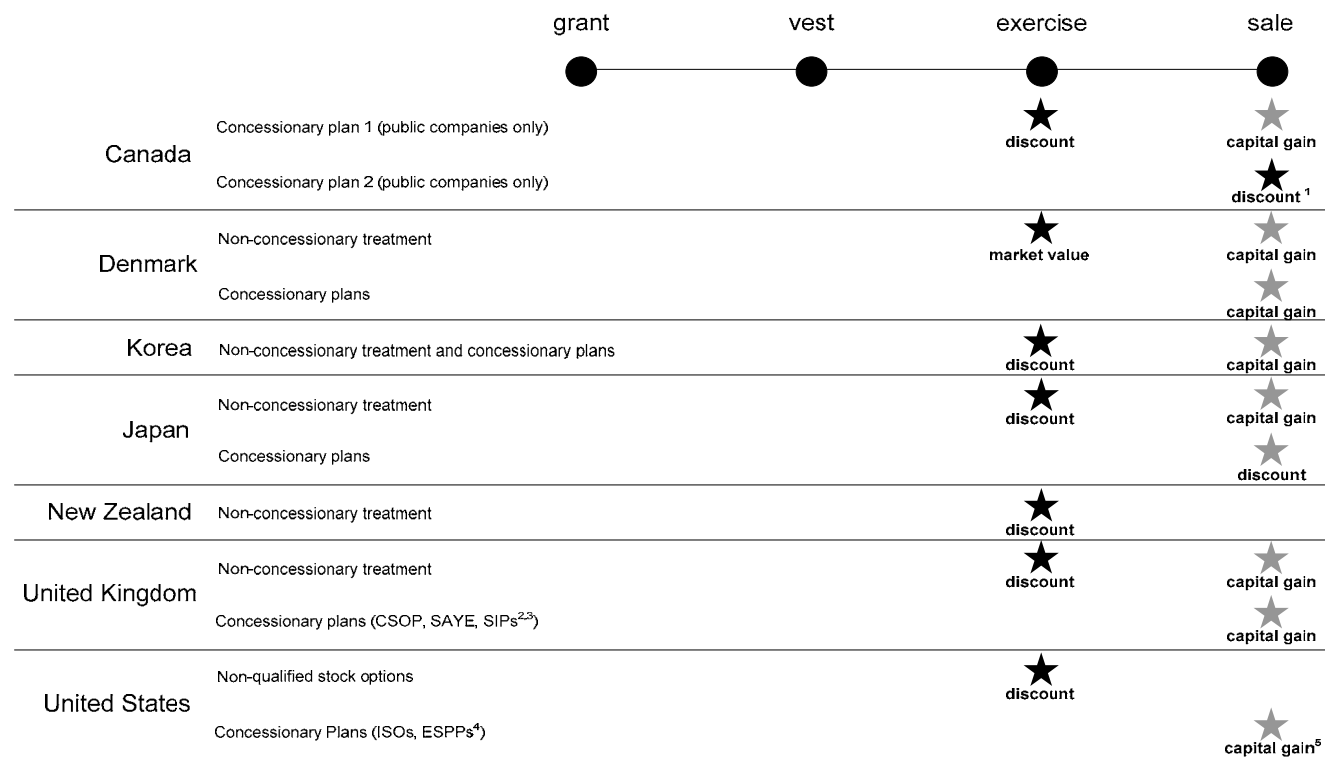
Therefore, the point at which an employee pays income tax (if at all) on equity-based payments varies across and within countries depending on whether the equity is eligible for concessionary treatment and the range of concessionary treatments available in that jurisdiction. Figure C.1 provides a comparison of approaches used in other countries.

US employee share schemes

Statutory schemes

In the United States, concessionary tax treatment is provided to ‘qualified’ or ‘statutory’ shares or options provided through approved employee share schemes. There are two types of statutory schemes used in the United States: incentive stock options and employee stock purchase plans (box C.3). In general, the employee is not able to dispose of statutory stock (and retain concessionary treatment) within two years of grant and one year of exercise and must exercise statutory options no later than three months after termination of employment.

Figure C.1 Points of taxation for employee options by country



1. Tax base = 50% of discount.

2. Company Share Option Plan (CSOP), Save As You Earn Plans (SAYE), Share Incentive Plans (SIPs).

3. In some circumstances, shares issued through SIPs may not attract any CGT or income tax.

4. Incentive Stock Options (ISOs), Employee Stock Purchase Plans (ESPPs).

5. While no income tax is payable on options that fulfil requirements for concessional treatment, Alternative Minimum Tax may be payable in addition to CGT.

Source: OECD (2005).

Box C.3 **Requirements for incentive stock options and employee stock purchase plans**

Incentive stock options — requirements include: a plan specifying the total number of shares that may be issued and the employees who are eligible to receive the options must be approved by shareholders within 12 months before or after plan adoption; the option exercise price must equal or exceed the fair market value of the underlying stock at the time of grant and the employee must not, at the time of grant, own stock representing more than 10 per cent of voting power of all stock outstanding (unless the option exercise price is at least 110 per cent of the fair market value and the option is not exercisable more than five years from the time of the grant).

Employee stock purchase plans — requirements include: the plan must be approved by shareholders within 12 months before or after the date the plan is adopted; no employee must receive an option grant if the employee, immediately after such grant, owns stock possessing 5 per cent more of the total combined voting power or value of all classes of stock of the employer; the terms of the plan must provide that the option price is not less than the lesser of 85 per cent of the fair market value of the stock at the time of grant, or 85 per cent of the fair market value of the stock at the time of exercise.

Source: US Internal Revenue Code, s. 422(b) and s. 423(b).

Generally, income tax is not payable at exercise for statutory stock (s. 421(a), US Internal Revenue Code). For example, incentive stock options are taxed at capital gains tax rates on disposal of the shares or options (thus, any gain received due to the increase in the market value of the share since time of grant is treated as a capital gain). However, where equity is offered at a discount (the fair market value of the share at time of grant exceeds the option price) under employee stock purchase plans, the discount is taxed at income tax rates on disposal of the share (s. 423(c), US Internal Revenue Code).

Typically, the level of benefit that can be conferred to executives through statutory stock is limited. Employee stock purchase plans must cover all employees (and thus cannot be designed to provide preferential treatment to executives). Furthermore, there are limits on the fair market value of the statutory stock options that can be exercised for the first time by any individual during any calendar year (\$100 000 limit for incentive stock options and \$25 000 limit for employee stock purchase plans).

Non-statutory schemes

Income tax is payable on non-statutory shares or options at grant where the equity-based payment has a 'readily ascertainable fair market value', there are no

restrictions on the transferability of the stock and it is not subject to ‘substantial risk of forfeiture’. Under the Internal Revenue Code:

The rights of a person in property are subject to a substantial risk of forfeiture if such person’s rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual. (s. 83(c)(1))

Unless an option is traded on an established market, it will generally not be treated as having a readily ascertainable fair market value. Where this applies, taxation will occur when the option is exercised or otherwise disposed of. The taxable amount is the fair market value of the option or share minus any consideration paid to acquire it.

There is also concessionary treatment available for employee stock ownership through retirement plans. For example, ‘401k’ plans where employees commit a percentage of their pre-tax salary to go towards the purchase of stock (both in the employer company and in other companies so to diversify risk). Employers may also match employee contributions.

409A rule

Where options have deferred vesting they may need to comply with the ‘409A Rule’ of the Internal Revenue Code enacted in 2004. This is the case for options that have performance conditions attached. The 409A rule provides that unless non-qualified deferred compensation complies with certain requirements regarding the timing of deferrals and distributions, all compensation deferred under the plan for the taxable year and all preceding taxable years will be included in gross revenue in the taxable year where requirements are not met. Where this occurs the tax imposed for the taxable year will be increased by an amount equal to 20 per cent of the compensation included in gross income plus a specified interest on deferred compensation in previous years.

To meet the 409A requirements deferred compensation must not be distributed earlier than: the specified date under the deferred compensation plan which was agreed to at the time of deferral; the date of separation from service; the date the participant becomes disabled, or deceased; or a change in ownership or effective control of the company.

CGT in the United States

In the United States, there are multiple CGT rates depending on the length of time the asset is held and the taxpayer’s marginal tax rate. When a capital asset is sold,

the difference between the amount received for the asset and what the individual paid to acquire it, is the capital gain or loss. Capital losses on investment property can be deducted, but losses on property held for personal use cannot.

Short-term capital gains are taxed at the taxpayer's marginal income tax rate, and apply where the investment is held for a year or less prior to disposal. Long-term capital gains are taxed at a lower rate and apply where the investment is held for more than a year. For tax years after 2007, individuals in the lowest two income tax brackets are taxed at 0 per cent for long-term net capital gains, for individuals in other income tax brackets the long-term net capital gains rate remains at 15 per cent (for tax years prior to and after 2007).

Where capital losses exceed capital gains, the excess can be deducted, up to an annual limit of \$3000 (or \$1500 where the taxpayer is married but filing separately). Where the total net capital loss is more than the yearly limit on capital loss deductions, any unused capital losses can be carried over to the next year and treated as if incurred in that following year.

UK employee share schemes

There are several types of approved share or option plans in the United Kingdom which receive concessional tax treatment. Generally these plans provide only limited benefits to executives.

Approved options plans include: Company Share Option Plans (CSOPs), Save As You Earn (SAYE) plans and Enterprise Management Incentive plans (box C.4). Generally, there is no income tax levied on approved option plans. However, CGT is applicable on disposal of the shares and — for options acquired on or after 10 April 2003 — is levied on the difference between the disposal proceeds and the amount paid for the option (if any) plus the exercise price (HM Revenue and Customs 2009a).

Share Incentive Plans (SIPs) enable companies to provide employees with shares that receive concessional tax treatment (box C.5). Employees who receive free or discounted shares through SIPs are able to pay limited or no tax on the shares they acquire under the plan. The taxation treatment for shares under SIPs depends on the type of shares issued under the plan and the length of time shares are held. If the employee keeps their shares in the plan until they sell them, CGT is not applicable, however, if the shares are sold after exiting the plan CGT will apply. Furthermore, in the case of partnership shares, SIPs enable employees to purchase shares before tax is deducted from salary, which reduces the amount of salary on which tax is ultimately levied on.

Box C.4 **Approved employee options plans in the United Kingdom**

Company Share Option plans (CSOPs) — must have an exercise price equal to the market rate of the underlying share on the date of grant and generally the underlying shares must not be subject to any restrictions other than restrictions that apply to all shares of the same class. At any one time, an employee is not permitted to hold unexercised CSOP options with an aggregate value in excess of £30 000 (HM Revenue and Customs 2009a). Qualifying conditions include that the option must not be exercised within three years of the date of grant or the date on which the employee last exercised a CSOP option in a tax favoured manner (s. 524, UK *Income Tax (Earnings and Pensions) Act 2003*).

Save As You Earn (SAYE) option plans — must be offered to all employees and full-time directors of the company. The exercise price of the SAYE option can be set at a discount to the market value of the underlying shares of up to a maximum of 20 per cent of the market value. The plan must only provide options for ordinary shares with no restrictions on these shares other than restrictions that apply to all shares of the same class (s. 516 and schedule 3, *Income Tax (Earnings and Pensions) Act*).

Monthly contributions to the SAYE plan can range between £5 to £250 and employees are able to choose varying contract lengths of three, five or seven years. At the end of the contract term the employee has the choice of withdrawing their money from the savings contract (together with a bonus) or using this money to exercise the SAYE option. SAYE options receive concessionary tax treatment where exercise occurs three years after grant or within three years under specific circumstances (for example injury, disability or redundancy) (HM Revenue and Customs 2009b).

Enterprise Management Incentive Plans — designed to help small, higher risk companies recruit and retain employees and provide these employees with incentives for investing their time and skills in the company. Companies must be independent trading companies with gross assets of no more than £30 million. Qualifying companies can grant share options with a market value of up to £120 000 for each qualifying employee, subject to a total share value cap of £3 million to all employees (HM Revenue and Customs 2009c). As opposed to CSOPs and SAYE plans which require approval from HM Revenue and Customs, enterprise management incentive plan options must be submitted to HM Revenue and Customs, but they do not require approval (OECD 2005).

Unapproved option plans

Unapproved option plans — termed as such because they do not need to fulfil any particular conditions — offer greater flexibility and are commonly used in the United Kingdom, often alongside approved plans (DG Enterprise 2002). These sorts of plans are likely to be more commonly used for executives.

Generally, an unapproved option is not taxable when granted, except in situations where the option is granted at a discount to the current market value and is exercisable more than ten years after the grant date. Otherwise, unapproved options are taxable on exercise at income tax rates, with tax levied on the difference between the exercise price and the market value of the shares at the date of exercise. CGT is due (when the shares are disposed of) on any increase in the value of the shares post exercise.

CGT in the United Kingdom

In the United Kingdom from 2008-09 there is a single rate of CGT for individuals, trustees and personal representatives of 18 per cent. Prior to this, the rates of CGT for individuals were 10 per cent, 20 per cent and 40 per cent depending on income levels. Generally, CGT in the United Kingdom is not payable on the sale of personal cars and the principal home. Furthermore, there is an annual exempt amount of £9600 for an individual (for 2008-09). This allowance enables individuals to make some capital gains without paying tax (HM Revenue and Customs 2009e).

Box C.5 Approved employee share plans in the United Kingdom

Share Incentives Plans (SIPs) — must be made available to all employees (both part-time and full-time). There are four types of shares that can be offered by employers under SIPs:

'Free shares' — with a maximum value of up to £3000 per qualifying employee each tax year. The number of free shares allocated can vary by employee with reference to their remuneration, length of service, or hours worked.

'Partnership shares' — where a company deducts agreed amounts from an employee's salary and arranges for shares to be purchased with the proceeds. The deductions must not exceed £1500 in any tax year and ten per cent of the employee's total salary for the next tax year.

'Matching shares' — free shares awarded by the company to match the partnership shares bought by the employee out of his or her salary. They may be awarded using any ratio, subject to a maximum of two matching shares for each partnership share.

'Dividend shares' — where a company allows an employee to use dividends with a maximum value of up to £1500 from their plan shares each year to buy further shares in the company.

Source: HM Revenue and Customs (2009d).

C.2 Taxation of termination payments

Australian taxation arrangements

There are several tax concessions provided for termination payments in Australia, varying depending on whether termination is voluntary or due to genuine redundancy or rationalisation of the organisation. The extent of the concession is capped and can depend on the length of service of the employee and their age. Unlike in other jurisdictions, such as the United States, there is no explicit tax treatment for executives in relation to termination in Australia.

Employment termination payments

Payments made in consequence of termination of employment, and received within 12 months of termination are treated as ‘Employment Termination Payments’ in the ITAA 1997. However, while there must be some connection between the payment and termination, termination does not need to be the dominant cause of the payment. Consequently, the definition of employment termination payments in the legislation is broad enough to capture most payments from an employer surrounding the termination of employment (notes to the ITAA 1997).

Employment termination payments can be made on retirement, death, resignation or involuntary termination and include: payment in lieu of notice, payment for unused rostered days off or unused sick leave, ‘golden handshake’ or gratuity payments, compensation for loss of job, payments for loss of future superannuation payments, payments in respect of a genuine redundancy or paid under an early retirement scheme that exceed the tax-free limit (ATO 2007; s. 82.135, ITAA 1997).

Payments that are not considered employment termination payments include superannuation benefits, payments from a pension or an annuity, any unused annual leave or long service leave payments and the tax-free part of a genuine redundancy payment or an early retirement scheme payment (s. 82.135, ITAA 1997).

Employment termination payments are concessionally taxed up to a cap of \$140 000 (for the 2007-08 year indexed annually), at a rate of:

- 15 per cent for a recipient at their ‘preservation age’
- 30 per cent for a recipient below their ‘preservation age’.

Any excess above the cap which is not tax free is taxed at the top marginal rate.

Genuine redundancy payments

A genuine redundancy payment refers to a payment:

- received by an employee who is dismissed from employment because the employee's position is genuinely redundant
- not greater than the amount that could reasonably be expected had the parties been dealing at arm's length
- not in lieu of superannuation benefits
- where the dismissed employee is not older than 65
- where the termination is not at the end of a fixed period of employment
- where there is no arrangement to employ the dismissed employee after the termination.

Dismissal is taken to mean where all employment with the employer is severed, except in situations where the employee holds an office with the employer at the same time as having a common law employment relationship with the same employer. An example of this is where a person is both a director of the employer company and a common law employee and is terminated from one of these two capacities.

Genuine redundancy payments are tax-free up to a limit (s. 83.175, ITAA 1997), and there are several components of a genuine redundancy with tax treatment varying by component:

- Voluntary termination element — the amount that could reasonably be expected to be received by the employee if he or she had voluntarily terminated employment at the time of being dismissed. This component is subject to tax as an employment termination payment if it is received no later than 12 months after the termination. Otherwise, this element of the payment is taxed as ordinary assessable income.
- Tax free amount — the extent to which the payment is tax-free will depend on the amount of the payment and the total number of whole years of employment to which the payment relates (s. 83.170, ITAA 1997).
- Taxable amount — any amount of genuine redundancy payment in excess of the tax-free amount will be taxable as an employment termination payment. This is so even where the amount is received more than 12 months after employment is terminated.

Genuine redundancy payments do not include payments such as superannuation benefits, pensions or annuities, unused annual leave payments, or unused long service leave payments.

Early retirement scheme

An approved early retirement scheme provides for early retirement of a specified class of employees with a view to rationalising or reorganising the operations of the employer.

Early retirement schemes must be approved by the Commissioner of Taxation to receive concessional tax treatment. The following three conditions are required to be met for approval:

- The scheme is available to broad groups of employees.
- The scheme is to be implemented with a view to reorganising the employer's business operations.
- The employer applies to the Commissioner of Taxation for approval before making any payments.

A payment under such a scheme is an approved early retirement scheme payment to the extent that it exceeds the amount that could reasonably be expected to have been received if the employee had voluntarily retired at the same time. Approved early retirement scheme payments are taxed in the same way as genuine redundancy payments.

International taxation arrangements

Since the mid-1980s the United States has imposed a 20 per cent tax on 'excess golden parachute payments'. 'Golden parachutes' are termination payments that are paid out due to changes in control or ownership of the corporation. An 'excess golden parachute' is where the value of the termination payment triggered due to the change in control or ownership exceeds the employee's base salary by 300 per cent. This rule only applies to disqualified individuals who are highly compensated (remunerated in the top 1 per cent of employees in the corporation).

Tax is paid on the value of total termination payments (that were contingent on the change in control or ownership) minus base salary. Payments which an employee can show are reasonable compensation for personal services actually rendered may not be counted, or may reduce the value of the excess payment that tax is paid on.

The US *Emergency Economic Stabilization Act 2008* expanded the definition of a parachute payment to include termination payments linked to an involuntary termination of the executive by the employer or in connection with bankruptcy, liquidation or receivership of the employer. This amendment is effective for payments made during an ‘applicable taxation year’ by an ‘applicable employer’ with respect to severance of a ‘covered executive’ occurring during the Troubled Asset Relief Program (TARP) authorities period (box C.6).

Recently there have been moves in some jurisdictions to introduce similar taxes on termination payments to the United States. In January 2009, the Dutch introduced tax law which imposes an additional tax of 30 per cent on the employer on the amount by which the termination payment exceeds an employee’s annual salary — this only applies where the annual salary is more than €500 000.

In mid 2009, the Portuguese government approved a bill — yet to be voted on in Parliament — which taxes bonuses paid to executives when ceasing their contract and imposes a penalty tax of 35 per cent on the company where the bonus is not linked to performance indicators agreed prior to termination (Nuncio 2009).

C.3 Taxation of bonuses

Australian taxation arrangements

There is currently no special taxation of bonuses in Australia. Cash bonuses are taxed as ordinary income subject to marginal income tax rates in the income year in which they are received, and are not differentiated from other forms of income.

Box C.6 Troubled Asset Relief Program terminology

Applicable employer — refers to any financial institution from whom troubled assets, of over \$300 million in total, are acquired under TARP.

Applicable taxable year — refers to a year where the aggregate amount of assets acquired under TARP from the employer in that taxable year, when added to the amount acquired from the employer under TARP for all preceding taxable years, exceeds \$300 million.

Covered executive — refers to an individual employed by an applicable employer at any time during an applicable taxation year. Covered executives are limited to the chief executive officer, chief financial officer and the three highest compensated officers of the applicable employer, taking into account only employees employed during the taxable year that includes any portion of the TARP authorities period.

Source: US *Emergency Economic Stabilisation Act 2008*, s. 302.

International taxation arrangements

In the United States, bill HR1586 was passed by the US House of Representatives in March 2009 and is now being considered in the Senate. If passed it would impose a 90 per cent federal income tax on recipients of any retention payment, incentive payment or other bonus paid after 31 December 2008 by a company or an affiliate of a company that received more than \$5 billion under the Emergency Economic Stabilization Act. The tax would not apply to:

- bonuses paid after the company reduces the aggregate amount of Emergency Economic Stabilization Act capital infusions to \$5 billion or less
- employers who irrevocably waive the employee's entitlement to such payment
- employees who return their payment to the employer before the close of the taxable year in which such payment is due
- commissions, welfare or fringe benefits, or expense reimbursements.

In December, the UK Chancellor announced plans for a one-off tax on bankers' bonuses as part of the pre-Budget report. The tax will involve a temporary levy (applied from 9 December 2009 to the end of the financial year in April 2010) of 50 per cent on any individual 'discretionary' bonus paid above £25 000 (HM Treasury (United Kingdom) 2009). Thus, bonuses guaranteed by contract are exempt. It is intended that banks, rather than the bankers, pay the levy. Bankers will still pay ordinary income tax on any bonus or salary received.

C.4 Allowable tax deductions for employers

Australian taxation arrangements

In Australia, companies are able to claim a deduction for salaries and wages paid to employees. Unlike in the United States (see below), there are no limits placed on this deduction. However, the issue of shares or options by a company to employees will generally not involve any cost to the employer and therefore is not an eligible deduction in Australia.

Where an employer is providing equity to employees under an employee share scheme (which provides eligible employees with access to a \$1000 tax exemption) a deduction of up to \$1000 per employee is allowed (irrespective of whether the employee is eligible for the \$1000 tax exemption due to their income levels).

International taxation arrangements

The US Internal Revenue Code allows company tax deductions for ‘all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business’ (s. 162(a), Internal Revenue Code). This includes a reasonable allowance for salaries or other compensation for personal services actually rendered. Under section 162(m), the Code caps deductions for remuneration of the CEO and four other highest paid officers in the corporation to \$1 million each in any taxable year. However, this cap does not include performance-based compensation.

Under the legislation, performance-based compensation is defined as remuneration payable solely on account of the attainment of one or more performance goals, and only where:

- the performance goals are determined by a remuneration committee which is comprised solely of two or more outside directors. Outside directors are defined as a person who: is not a current employee of the corporation; is not a former employee of the corporation receiving compensation for prior services; has not been an officer of the corporation and does not receive remuneration, either directly or indirectly, from the corporation in any capacity other than as a director
- the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration
- before any payment of remuneration, the remuneration committee certifies that the performance goals and any other material terms were in fact satisfied (s. 162(m), Internal Revenue Code).

Recent guidance published by the US Internal Revenue Service state that employee remuneration packages that provide for payments upon termination without regard to performance do not qualify as performance-based compensation exempt from the section 162(m) deduction limit (Internal Revenue Service 2008). The new ruling means that even where termination events never occur, provisions that provide for payment without regard to performance on termination will disqualify all payments made under that arrangement from being tax deductible. The only permissible conditions for payment without performance are death, disability, or change of control.

For corporations receiving funding of over \$5 billion under the Emergency Economic Stabilization Act, the deduction limit has been amended from \$1 000 000 to \$500 000 for executive remuneration and deferred deduction executive

remuneration. Furthermore, the exception for performance-based compensation does not apply. This provision applies to payments made during an ‘applicable taxation year’ by an ‘applicable employer’ with respect to a ‘covered executive’ (box C.6).