


CR 2004/120 - Income tax: Microsoft Corporation employee option plans

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Class Ruling

Income tax: Microsoft Corporation employee option plans

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Preamble

The number, subject heading, **What this Class Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. CR 2001/1 explains Class Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.

What this Class Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are sections:
- 139CB of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - 139CC of the ITAA 1936;
 - 139E of the ITAA 1936;
 - 177D of the ITAA 1936;
 - 104-10 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - 104-25 of the ITAA 1997; and
 - 104-155 of the ITAA 1997.

Class of persons

3. The class of persons to which this Ruling applies is the Australian resident employees of the following subsidiaries of Microsoft Corporation (Microsoft):

- Microsoft Pty Limited;
- Great Plains Pty Limited;

- Navision Pty Limited; and
- Microsoft Global Resources GmbH,

who, as at the date of the amendments to the option terms, have been granted options to acquire shares under the Microsoft Corporation, 1991 Stock Option Plan, and the Microsoft Corporation, 2001 Stock Option Plan (the Plans), and the options have not been exercised at or before the date of the amendments.

Former employees whose employment was terminated ninety days prior to the amendment date are included in the class of persons.

The class of persons is referred to as participating employees.

Qualifications

4. The Commissioner makes this Ruling based on the precise arrangement identified in this Ruling.
5. The class of persons defined in this Ruling may rely on its contents provided the arrangement actually carried out is carried out in accordance with the arrangement described in paragraphs 9 to 18 of this Ruling.
6. If the arrangement actually carried out is materially different from the arrangement that is described in this Ruling, then:
 - this Ruling has no binding effect on the Commissioner because the arrangement entered into is not the arrangement on which the Commissioner has ruled; and
 - this Ruling may be withdrawn or modified.
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Date of effect

8. This Ruling applies to the income year ended 30 June 2005. However, this Ruling does not apply to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). Furthermore, this Ruling applies to the extent that:

- it is not withdrawn by notice in the *Gazette*;
- it is not taken to be withdrawn by an inconsistent later Public Ruling; and
- the relevant tax laws are not amended.

Arrangement

9. The arrangement that is the subject of the Ruling is described below. The description is based on the following documents:

- the application for Class Ruling received on 30 July 2004; and
- letter received on 11 August 2004.

These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description.

Note: certain information received has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information legislation.

10. Employees of Microsoft Pty Limited, Great Plains Pty Limited, and Navision Pty Limited (subsidiaries of Microsoft) have been granted options to acquire shares in Microsoft under the Plans.

11. The options granted to Australian employees under the Plans constitute qualifying rights for the purposes of Division 13A of Part III of the ITAA 1936.

12. The options are subject to vesting during employment and forfeiture on termination of employment.

13. On 20 July 2004, Microsoft announced that it will distribute a special cash dividend of US\$3 per share to its shareholders of record on 17 November 2004.

14. A consequence of the special cash dividend is a reduction in the value of unexercised options. In order to preserve their value, Microsoft proposes to amend the terms of the options outstanding under the Plans as at the date of amendment.

15. Amendment to the terms will reduce the exercise price and increase the number of shares subject to the options, such that holders of the outstanding options are not disadvantaged as a result of the special cash dividend. Amendment to the terms will be determined based on 'ratio' and 'spread' tests.

16. The 'ratio' test ensures that the ratio of the option exercise price to the fair market value of the shares immediately after the dividend distribution is not more favourable than the ratio of the option exercise price to the fair market value of the shares immediately before the dividend distribution.

17. The 'spread' test ensures that the spread of options against the shares is maintained following the dividend distribution.

18. Amendment to the terms will take place prior to the opening of the stock market on 15 November 2004.

Ruling

19. An unexercised option held by a participating employee under either of the Plans is a qualifying right for the purposes of Division 13A of Part III of the ITAA 1936 and this will not change as a result of the proposed amendments to the terms of the option contract as described in the Arrangement.

Where an employee has made an election

20. The reduction in the exercise price and increase in the number of shares held subject to the options have no impact on the discount calculated under subsection 139CC(2) of the ITAA 1936.

Capital gains tax

21. When an employee acquires an option they also acquire an option for capital gains tax (CGT) purposes.

22. As the amendments do not result in a change of ownership of an unexercised option, CGT event A1 does not happen as a result of the amendments (section 104-10 of the ITAA 1997).

23. As the amendments do not bring to an end the ownership of the unexercised option held by a participating employee, CGT event C2 does not happen as a result of the amendments (section 104-25 of the ITAA 1997).

24. The amendments will result in CGT event H2 happening as the amendments are 'acts, transactions or events' in relation to the unexercised option that do not result in an adjustment being made to the cost base or reduced cost base of the option (section 104-155 of the ITAA 1997). However, this event will not affect the tax position of a participating employee. There will be no capital gain or capital loss as a result of the event as no capital proceeds are derived, or incidental costs incurred, by a participating employee in respect of the event.

Where an employee has not made an election

25. The amendments do not result in the happening of a cessation time under paragraph 139CB(1)(a) of the ITAA 1936 as there has not been a disposal of the option.

Capital gains tax

26. The analysis in paragraphs 21 to 24 also applies to a participating employee who has not made an election under section 139E.

Section 177D of Part IVA of the ITAA 1936

27. Section 177D of Part IVA of the ITAA 1936 is not considered to apply in respect of the variation to the option contract terms as the amendments do not result in a tax benefit to the participating employee.

Explanation

Amendments to option contract

28. The amendments to terms in respect of exercise price and shares subject to each option constitute variations to the initial option contract. The amendments do not result in a new option contract.

29. The issue of when an agreement is varied or rescinded was considered by the High Court of Australia in *Tallerman & Co Pty Limited v. Nathan's Merchandise (Vic) Pty Limited* (1957) 98 CLR 93 (the *Tallerman* case). Justice Taylor stated at page 144 that:

It is firmly established by a long line of cases... that the parties to an agreement may vary some of its terms by a subsequent agreement. They may, of course, rescind the earlier agreement altogether, and this may be done either expressly or by implication, but the determining factor must always be the intention of the parties as disclosed by the later agreement. Variation, of course, may involve partial rescission as is pointed out in Salmond and Williams on Contracts 2nd ed. (1945) pp. 488, 489, but 'Partial rescission... does not completely destroy the contractual relation between the parties. It merely modifies that relation by cutting out part of the rights and obligations involved therein, with or without the substitution of new rights and obligations in their place. Partial rescission is not the extinction of the contract but the variation of it'...

30. The *Tallerman* case was cited with approval and applied in *Federal Commissioner of Taxation v. Sara Lee Household & Body Care (Australia) Pty Limited* [2000] HCA 35; (2000) 201 CLR 520. In this regard, the majority of the High Court of Australia stated at CLR 534 that:

The manifest intention of the parties was not that the agreement of 31 May 1991 should be wholly rescinded and replaced by a new agreement, but that the rights and liabilities under, and the mode of performance of, the agreement, should be varied in certain respects.

31. It is considered that the amendments are variations of the original option contract made pursuant to the Plans as the terms of the original contract, such as the exercise price and the number of

shares subject to an option, are not rescinded but only varied by the amendments.

Division 13A of Part III of the ITAA 1936

32. An unexercised option held by a participating employee under either of the Plans is a qualifying right for the purposes of Division 13A of Part III of the ITAA 1936.

Where an employee has made an election

33. Where a participating employee has made an election under section 139E, the discount given in relation to the option will be included in their assessable income in the year of income in which the option was acquired under subsection 139B(2).

34. Under subsection 139CC(2), the discount to be included in the participating employee's assessable income will be equivalent to the market value of the option at the time when it was acquired less any consideration paid or given by the participating employee as consideration for the acquisition of the option. The market value at this time is worked out under sections 139FA to 139FF.

35. The discount calculated under subsection 139CC(2) will not change because of the amendments. The market value of the option is determined at the date the option was acquired and is based on the exercise price of the option at that time.

Capital gains tax

36. Where a participating employee has made an election under section 139E of the ITAA 1936, the first element of the cost base and reduced cost base of the unexercised option is determined in accordance with subsection 130-80(2) of the ITAA 1997. This is the market value of the unexercised option (as determined under section 139FC of the ITAA 1936) at the date of acquisition of the unexercised option. The cost base of the unexercised option is not adjusted as a result of the amendments.

CGT event A1

37. CGT event A1 happens where there has been a change of ownership in the unexercised option from the participating employee to another entity (section 104-10 of the ITAA 1997).

38. The amendments do not result in a change of ownership of the unexercised option and the participating employee continues to hold the unexercised option granted under the initial option contract. The initial option contract is only varied by the amendments.

CGT event C2

39. CGT event C2 happens if ownership of an intangible CGT asset ends in certain ways (subsection 104-25(1) of the ITAA 1997).

40. The amendments do not bring the participating employee's ownership of the unexercised option to an end. The participating employee continues to hold the unexercised option granted under the initial option contract, and accordingly CGT event C2 will not happen.

CGT event H2

41. CGT event H2 happens if 'an act, transaction or event' occurs in relation to a CGT asset and the act, transaction or event does not result in an adjustment being made to the asset's cost base or reduced cost base (subsection 104-155(1) of the ITAA 1997).

42. CGT event H2 will happen on the making of the amendments as these are acts, transactions or events in relation to the unexercised option that do not result in an adjustment being made to the cost base or reduced cost base of the unexercised option.

43. A capital gain is made if the capital proceeds from CGT event H2 are more than the incidental costs incurred in relation to the event. A capital loss is made if the capital proceeds from the event are less than the incidental costs.

44. Under subsection 116-20(2) of the ITAA 1997, the capital proceeds from CGT event H2 is the money or other consideration received or entitled to be received because of the act, transaction or event. Taxation Ruling TR 95/3 provides that consideration extends 'to any benefit received by one party or detriment suffered by the other party'.

45. In this case the Commissioner does not consider that the reduction in the exercise price or the increase in the number of shares subject to the options constitute capital proceeds in respect of CGT event H2. It is only when a subsequent CGT event happens to the unexercised option that any capital proceeds may be received. When that CGT event happens any capital proceeds would relate to the subsequent CGT event and not to the CGT event H2 that happened when the terms of the unexercised option were varied.

46. Accordingly, the participating employee will make no capital gain or capital loss from CGT event H2 as there are no capital proceeds derived from the event and no incidental costs are incurred by the participating employee in respect of the event.

Where an employee has not made an election

47. Where the participating employee has not made an election under section 139E, the discount given in relation to the option will be included in their assessable income in the year of income in which the cessation time occurs, pursuant to subsection 139B(3).

48. The relevant amendments do not result in the happening of a cessation time under paragraph 139CB(1)(a) as there has not been a disposal of the option.

49. The participating employee will include in assessable income, in the year of income in which the cessation time occurs, the discount given on the option as calculated under subsection 139CC(3) or 139CC(4). If the cessation time under subsection 139CB(1) happens when the participating employee exercises the option to acquire the share in Microsoft, the exercise price paid or given for the exercise of the option will be the reduced exercise price in accordance with the varied option contract.

Capital gains tax

50. The analysis in paragraphs 36 to 46 also applies to a participating employee who has not made an election under section 139E.

Fringe benefits tax

51. The definition of fringe benefit in subsection 136(1) of the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986) expressly excludes a benefit in the form of a share or right acquired under an 'employee share scheme' within the meaning of Division 13A.

52. As the options held by participating employees were acquired under an employee share scheme as defined in Division 13A, the amendments to the terms of the option contracts is a matter properly dealt with in Division 13A and the CGT provisions. As such it does not give rise to a fringe benefit for the purposes of the FBTAA.

Paragraph 26(e) of the ITAA 1936

53. Pursuant to paragraph 139DE(a) of the ITAA 1936, paragraph 26(e) does not apply to a share or right acquired under an employee share scheme.

54. Accordingly, paragraph 26(e) of the ITAA 1936 does not apply as the options held by participating employees were acquired under an employee share scheme as defined in Division 13A.

Part IVA of the ITAA 1936

55. Part IVA of the ITAA 1936 applies to schemes entered into or carried out after 21 May 1981 where it would be concluded that a person or persons entered into or carried out the scheme for the dominant purpose of enabling the 'relevant taxpayer' to obtain a tax benefit.

56. Tax benefit is defined at section 177C to include, among other things, an amount which, but for the scheme, would have been or might reasonably be expected to have been included in the assessable income of the taxpayer.

57. In the present case the arrangement that is the subject of the ruling, that is, the arrangement to amend the terms of the participating employees' option agreements, is not a scheme that enables the employees to obtain a tax benefit within the meaning of section 177C. Accordingly, section 177D does not apply to the arrangement.

Detailed contents list

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Commissioner of Taxation

10 November 2004

<i>Previous draft:</i>	- ITAA 1936 139FAA
Not previously issued as a draft	- ITAA 1936 139FB
	- ITAA 1936 139FC
<i>Related Rulings/Determinations:</i>	- ITAA 1936 139FD
CR 2001/1; TR 92/1; TR 92/20;	- ITAA 1936 139FE
TR 95/3; TR 97/16	- ITAA 1936 139FF
	- ITAA 1936 Pt IVA
<i>Subject references:</i>	- ITAA 1936 177C
- amendment	- ITAA 1936 177D
- capital gains tax	- ITAA 1997 104-10
- cost base	- ITAA 1997 104-25
- election	- ITAA 1997 104-25(1)
- employee option scheme	- ITAA 1997 104-155
- no election	- ITAA 1997 104-155(1)
- option contract	- ITAA 1997 116-20(2)
- options	- ITAA 1997 130-80(2)
- rights	- FBTAA 1986 136(1)
- variation	- Copyright Act 1968
	- TAA 1953 Pt IVAAA
<i>Legislative references:</i>	<i>Case references:</i>
- ITAA 1936 26(e)	- Federal Commissioner of
- ITAA 1936 Pt III Div 13A	Taxation v. Sara Lee Household &
- ITAA 1936 139B(2)	Body Care (Australia) Pty Limited
- ITAA 1936 139B(3)	[2000] HCA 35; (2000) 201 CLR
- ITAA 1936 139CB	520
- ITAA 1936 139CB(1)	- Tallerman & Co Pty Limited v.
- ITAA 1936 139CB(1)(a)	Nathan's Merchandise (Vic) Pty
- ITAA 1936 139CC	Limited (1957) 98 CLR 93
- ITAA 1936 139CC(2)	<i>Other references:</i>
- ITAA 1936 139CC(3)	- Salmond and Williams on
- ITAA 1936 139CC(4)	Contracts, 2nd edition (1945)
- ITAA 1936 139DE(a)	
- ITAA 1936 139E	
- ITAA 1936 139FA	

ATO references

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