CR 2004/42 - Income tax: Employee Share Schemes: Reasonable valuation method for market value of unlisted options: McKinsey Pacific Rim, Inc.

Class Ruling

Income tax: Employee Share Schemes: Reasonable valuation method for market value of unlisted options: McKinsey Pacific Rim, Inc.

Contents Para

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:

- 139B of the *Income Tax Assessment Act 1936* (ITAA 1936);
- 139C of the ITAA 1936;
- 139CB of the ITAA 1936;
- 139CC of the ITAA 1936;
- 139CD of the ITAA 1936;
- 139E of the ITAA 1936;
- 139FA of the ITAA 1936;
- 139FB of the ITAA 1936;
- 139FC of the ITAA 1936;
- 139FD of the ITAA 1936;
- 139FF of the ITAA 1936;

- 139FK of the ITAA 1936;
- 104-10 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- 112-15 of the ITAA 1997;
- 116-10 of the ITAA 1997;
- 116-20 of the ITAA 1997;
- 116-30 of the ITAA 1997;
- 130-80 of the ITAA 1997;
- 130-83 of the ITAA 1997; and
- 134-1 of the ITAA 1997.

Class of persons

3. The class of persons to which this Ruling applies is Australian resident employees who are Management Group Members (participating employees) of McKinsey Pacific Rim, Inc (MPR), who receive options to acquire shares in McKinsey & Company, Inc (McKinsey) under the McKinsey Pacific Rim 2003 Stock Option Plan (SOP).

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 21.

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 year of income ended 30 June 2004 and subsequent years. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a dispute agreed to before the date of the Ruling.

Arrangement

9. The arrangement that is the subject of the Ruling is described below. This description is based on the documents listed below. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of arrangement are:

- The McKinsey Pacific Rim, Inc. 2003 Stock Option Plan (SOP); and
- The McKinsey & Company, Inc. Articles of Incorporation (the Articles);
- The application letter for a Class Ruling from Deloitte Lawyers dated 6 November 2003; and
- A letter from PricewaterhouseCoopers LLP confirming the book value of a share in McKinsey at 31 December 2001 and 2002 that has been determined in accordance with United States accounting standards.

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. As part of its Australian remuneration strategy, McKinsey is proposing to establish an Australian SOP for certain participating employees.

11. The application letter states that options issued under the SOP will be qualifying rights for the purposes of section 139CD of the ITAA 1936.

12. Each option granted under the SOP will allow a participating employee to subscribe for one fully paid ordinary share in McKinsey.

13. Options granted under the SOP will be granted for no consideration.

14. Each option will be exercisable at the exercise price specified in the option certificate. The exercise price will be not less than the market value of the underlying ordinary share in McKinsey on the date of grant as determined by the Articles, the 'Actual Book Value' (ABV). The directors may determine that the exercise price will include a premium over the market value as a performance incentive.

15. Under the SOP, time vesting schedules and performance benchmarks may be imposed as a condition of exercising an option. Where vesting conditions are imposed, it is proposed that any options granted under the SOP will vest over a period of 1-2 years.

16. Where vesting and performance benchmarks are satisfied, a participating employee may, instead of exercising a vested option, request McKinsey to buy back the option. The consideration to be paid for a vested option will be the market value of a share in McKinsey at that time, determined as above, less the exercise price of the option.

17. Options will have a term not exceeding 10 years and will lapse at the expiration of that period.

18. Options will lapse in the event that a trade sale or public listing of McKinsey occurs.

19. Upon cessation of employment with McKinsey, or any of its subsidiaries:

- any shares acquired as a result of exercising options must be sold to McKinsey at a price equal to market value at that time, and
- any unexercised vested options will
  - If cessation of employment is due to fraud or other illegal activity – lapse immediately, or
  - If cessation of employment is due to any other reason – become exercisable.

20. The Articles require all transactions in McKinsey shares to be undertaken at ABV and prohibit transactions in those shares at any value other than ABV.

21. For the purposes of the SOP, the market value of a McKinsey share on a particular day is said to be essentially, the net assets of McKinsey based on its financial reports, divided by the total number of issued shares.

Ruling

All references are to the Income Tax Assessment Act 1936 unless otherwise specified

22. A participating employee will acquire a qualifying right under an employee share scheme for the purposes of Division 13A of Part III (Div 13A) when an option is issued under the SOP. A participating employee will also acquire a right for the purposes of capital gains tax (CGT).

23. In respect of an option acquired or any shares acquired as a result of the exercise of an option under the SOP, an amount (the discount) will be included in the participating employee's assessable income in accordance with section 139B.

24. The amount of the discount given in relation to an option is determined under section 139CC and in particular circumstances the discount is calculated by reference to the market value of the option at the time it was acquired or alternatively at the cessation time.

Method of calculating the market value

25. The options in McKinsey (McKinsey options) are not listed on an approved stock exchange, therefore the market value of an option is determined by reference to section 139FC (unlisted rights). This requires a determination of the market value of the underlying share that may be acquired by exercising the option.

26. The shares in McKinsey (McKinsey shares) are also not listed on an approved stock exchange, so section 139FB allows the Commissioner to approve a reasonable method of calculating the arm's length value of an unlisted share.

27. The Commissioner accepts that the ABV method is a reasonable method of calculating the arm's length value of an unlisted McKinsey share for the purposes of paragraph 139FB(1)(b).

28. Where market value is subsequently referred to in this Ruling in particular in relation to subsection 139CC(4), subsection 130-80(2) of the ITAA 1997 and subsection 130-83(3) of the ITAA 1997, it should be read in conjunction with the above paragraph. This means that the ABV method is accepted as representing the market value for the purpose of these subsections.

Disposal of an option

29. Where a participating employee disposes of a McKinsey option prior to exercise, the CGT implications will depend on whether a participating employee has lodged a section 139E election.

Where an election is made

30. For CGT purposes, where a participating employee makes an election under section 139E, the first element of the cost base of an option is determined pursuant to subsection 130-80(2) of the ITAA 1997. This will be the market value of the McKinsey option at the time it is acquired as worked out under section 139FB by reference to the market value of the underlying McKinsey share.

31. Where a McKinsey option is disposed of prior to exercise, a participating employee will make a capital gain if the proceeds from disposal are more than the cost base. Where the option is sold to McKinsey at a market value (determined using the ABV method), the capital proceeds will be the money received from the sale of the option.

Where no election is made

32. Where a participating employee does not make an election under section 139E, the discount in relation to an option is included in the employee's assessable income in the year of income in which the cessation time occurs. The cessation time is the earlier of the time that a McKinsey option is disposed of or the time when the employee ceases employment with the employer or a holding company of the employer or a subsidiary, pursuant to section 139CB.

33. If the cessation time is when a McKinsey option is disposed of, the amount of the discount to be included in a participating employee's assessable income is calculated by reference to section 139CC and will be the amount of consideration received by the employee on disposal of the option.

34. Any capital gain or loss made as a consequence of such a disposal is disregarded.

35. If the cessation time is the time when the employee ceases employment (as defined in subsection 139CB(2)), the amount of the discount to be included in a participating employee's assessable income is calculated by reference to subsection 139CC(3) or (4).

36. Where a McKinsey option is disposed of within 30 days of the cessation time, the discount will be the amount of consideration received for the option pursuant to subsection 139CC(3).

37. Any capital gain or loss made as a consequence of such a disposal is disregarded.

38. Where a McKinsey option is not sold within 30 days of the cessation time, the discount will be the market value of the option at the cessation time, pursuant to subsection 139CC(4).

39. The first element of the cost base will be the market value of the McKinsey option at the cessation time, pursuant to subsection 130-83(3) of the ITAA 1997.

40. Where a McKinsey option is subsequently disposed of, a capital gain or loss arising will be the difference between the capital proceeds (in accordance with section 116-20 of the ITAA 1997) and the cost base, pursuant to subsection 104-10(4) of the ITAA 1997.

Disposal of a share

41. Where a participating employee disposes of a McKinsey share acquired as a result of exercising an option, the CGT implications will depend on whether a participating employee has lodged a section 139E election.

Where an election is made

42. For CGT purposes, where a participating employee makes an election under section 139E, the first element of the cost base of a share will be the market value of the option at the time it is acquired as worked out under section 139FB by reference to the market value of the underlying share.

43. Where a McKinsey share is disposed of, a participating employee will make a capital gain if the proceeds from disposal are more than the cost base. Where the share is sold to McKinsey at a market value (determined using the ABV method), the capital proceeds will be the money received from the sale of the share.

Where no election is made

44. Where a participating employee does not make an election under section 139E, the discount in relation to a McKinsey share acquired as a result of exercising an option, is included in the employee's assessable income in the year of income in which the cessation time occurs in relation to the option. The cessation time, pursuant to section 139CB, is the time when a McKinsey option is exercised.

45. Where a McKinsey share is disposed of in an arm's length transaction within 30 days of the cessation time, the discount included in assessable income at cessation time under subsection 139B(3) is calculated in accordance with subsection 139CC(3). It will be the consideration received on disposal of the share less the amount paid to exercise a McKinsey option.

46. Any capital gain or loss made as a consequence of such a disposal is disregarded.

47. Where a McKinsey share is not disposed of in an arm's length transaction within 30 days of the cessation time, the discount included in assessable income will be the market value of the share at the cessation time less the amount paid to exercise the McKinsey option, pursuant to subsection 139CC(4).

48. For CGT purposes, the first element of the cost base for such a share not sold within 30 days is the market value of that share at the cessation time, pursuant to subsection 130-83(3) of the ITAA 1997.

49. When a McKinsey share is subsequently disposed of, a participating employee will make a capital gain if the proceeds from disposal are more than the cost base. Where the share is sold to McKinsey at a market value (determined using the ABV method), the capital proceeds will be the money received from the sale of the share.

Explanation

50. Div 13A provides for the taxation treatment of shares and rights acquired under employee share schemes, ensuring they are subject to tax in the hands of employees and are not subject to fringe benefits tax.

51. To be dealt with under the provisions of Div 13A, an option must be acquired under an employee share scheme in accordance with section 139C. Further, to be a qualifying right an option must satisfy the conditions of section 139CD.

52. The application letter for this Ruling states that an option issued under the SOP is a qualifying right for the purposes of section 139CD.

53. Where an employer provides to an employee, in respect of their employment, shares or rights to acquire shares at a value less than the market value, an amount is included in the assessable income of the employee pursuant to section 139B. This amount is the discount given in relation to the share or right, which is calculated under section 139CC and is either the difference between:

- the market value at the time acquired; or
- the consideration received on disposal; or
- the market value at the cessation time;

and the consideration paid to acquire the share or right.

54. The discount is included in the employee's assessable income in the year in which the share or right is acquired pursuant to subsection 139B(2), or in the year the cessation time occurs pursuant to subsection 139B(3). The appropriate year of income is determined according to whether or not an election is made under section 139E.

55. As the amount of discount to be included in assessable income may rely on the market value of a share or right, it is necessary to refer to Subdivision F of Div 13A which contains special provisions about the market value of a share or right. Where shares or rights are not quoted on an approved stock exchange, sections 139FB and 139FC consider the method for calculating the market value of unlisted shares and rights respectively.

56. Under the McKinsey SOP, options to acquire shares are to be issued to participating employees, conditional upon time vesting schedules and certain performance benchmarks. Each option granted will allow the employee to subscribe for one fully paid ordinary share in McKinsey. Therefore, section 139FC must be considered.

Method of calculating the market value

57. The market value of a right, not listed on an approved stock exchange on a particular day, is determined by comparing the amount specified in paragraph 139FC(1)(a) with the amount specified in (1)(b) or (1)(c). The market value will be the greater of these amounts, unaffected by restrictions or conditions attaching to the shares or rights, pursuant to section 139FD.

58. The amount specified in paragraph 139FC(1)(a) is the market value of the share that may be acquired by exercising the right, less the lowest amount that must be paid to exercise the right to acquire the share. If the share is an unlisted share its value is arrived at under section 139FB.

59. If the right cannot be exercised more than 10 years after the day on which it was acquired, the market value arrived at under paragraph 139FC(1)(a) must be compared with the value arrived at under paragraph 139FC(1)(b). Otherwise, the value under paragraph 139FC(1)(a) must be compared with the value arrived at under paragraph 139FC(1)(c). In either situation, the greater of the two values arrived at is the market value.

60. As the McKinsey options will not have a term exceeding 10 years, the market value arrived at under paragraph 139FC(1)(a) must be compared with the value arrived at under subsection 139FC(1)(b).

61. The value of the right as determined under paragraph 139FC(1)(b) is the value determined in accordance with sections 139FJ to 139FN. According to subsection 139FK, Step 1 of this calculation can only be calculated if the market value of the underlying share that is the subject of the right is known. The market value of an unlisted share is determined using section 139FB.

62. Thus, section 139FB allows the taxpayer to determine the value of an underlying share for the purpose of calculating the market value of an unlisted right in section 139FC. More specifically, paragraph 139FB(1)(b) gives the Commissioner a discretion to approve certain methods of calculating the arm's length market value

of unlisted shares acquired by a taxpayer under an employee share scheme.

63. Generally, the market value of an unlisted share is the arm's length value of the share as calculated in accordance with a method approved in writing by the Commissioner as a reasonable method of calculating the arm's length value of unlisted shares.

64. According to the Articles of McKinsey, the formula for arriving at the ABV of a share on a particular day is based on the definition of Book Value (BV) of a share, which is the net assets based on financial reporting divided by the total number of shares on issue. The ABV of a share on a particular day is determined by averaging on a day's basis, the BV on the most recent financial reporting date prior to and following that particular date.

65. In the general market, the ABV of shares may not accurately represent the market value of those shares. However, because the Articles of McKinsey prohibit transactions in McKinsey shares at any value other than ABV and the SOP limits to whom the options and shares can be sold (essentially back to McKinsey), there is a restricted market. There is no other market in which McKinsey shares may be traded. Thus, providing the exercise price of the options does not include a premium over the market value, the ABV represents the market value as there is no other market in which the options or shares can be traded.

66. Therefore, the Commissioner accepts that the ABV method is a reasonable method of calculating the arm's length value and that value is the market value of an unlisted McKinsey share for the purposes of subsection 139FB(1).

Disposal of an option

67. Where a participating employee disposes of a McKinsey option prior to exercising the option, the CGT implications will depend on whether a participating employee has lodged a section 139E election.

Where an election is made under section 139E

68. A participating employee may make an election in accordance with section 139E, that subsection 139B(2) applies for the year of income in relation to each qualifying right. The year of income will be the year that the option is acquired.

69. For CGT purposes, Subdivision 130-D of the ITAA 1997 sets out what happens in relation to shares or rights acquired under an employee share scheme. The first element of the cost base of an option acquired under an employee share scheme is determined pursuant to subsection 130-80(2) of the ITAA 1997 and will be the market value of the option at the time it is acquired.

70. The market value of such an option is worked out under sections 139FA to 139FF as appropriate. In relation to a McKinsey option the market value is worked out under section 139FB by reference to the market value of the underlying McKinsey share. This is fully explained in paragraphs 57 to 66.

71. Where a McKinsey option is disposed of prior to exercising the option, the disposal will constitute a CGT event A1 as a change of ownership occurs in relation to the option pursuant to subsection 104-10(1) and (2) of the ITAA 1997. The capital gain or loss arising on the CGT event A1 will be the difference between the capital proceeds received and the cost base of the option in accordance with subsection 104-10(4) of the ITAA 1997.

72. Where a McKinsey option is sold to McKinsey at a market value that is determined using the ABV method, Division 116 of the ITAA 1997 determines what will be the capital proceeds from the disposal of the option which is a CGT event A1.

73. Section 116-20 of the ITAA 1997 contains the general rules about capital proceeds and section 116-10 contains modifications to those general rules that may be relevant. Subsection 116-10(2) is relevant if the event was not a dealing at arm's length and provides a market value substitution rule. Further, subsection 116-30(2) of the ITAA 1997 provides that where the capital proceeds are more or less than the market value, the capital proceeds are replaced with the market value.

74. However, a McKinsey option can only be sold to McKinsey at a market value that is determined using the ABV method which is accepted as being the market value for the purposes of subsection 139FB(1). Therefore, the capital proceeds will be the money received from the sale of the McKinsey option in accordance with section 116-20 of the ITAA 1997.

Where no election is made under section 139E

75. As a McKinsey option is a qualifying right, the discount in relation to that option is included in a participating employee's assessable income pursuant to subsection 139B(3) in the year of income in which the cessation time occurs. The cessation time will be determined in accordance with section 139CB.

76. The disposal of a McKinsey option can only occur prior to such option being exercised. Further, McKinsey options will have a term not exceeding 10 years and will lapse at the end of that term.

77. Therefore, for the purposes of section 139CB, the cessation time will be the earliest of:

- the time when the option is disposed of; or
- the time when the employee is no longer employed by any of the following:

- the employer;
- a holding company of the employer; and
- a subsidiary of the employer or of a holding company of the employer.

Cessation time is when an option is disposed of

78. Where the cessation time is the time when the option is disposed of, the amount of the discount is included in a participating employee's assessable income, pursuant to subsection 139B(3), as the McKinsey option is a qualifying right.

79. Where the option is disposed of in an arm's length transaction at the cessation time, the discount is calculated by reference to subsection 139CC(3). In accordance with the decision in paragraph 27, the Commissioner accepts that such a disposal has occurred in an arm's length transaction.

80. No consideration is provided by a participating employee to acquire a McKinsey option, therefore the discount will be the amount of consideration received by the employee on disposal of the McKinsey option, pursuant to subsection 139CC(3).

81. As a McKinsey option is a qualifying right and no election is made by a participating employee under section 139E, any capital gain or loss made on disposal is disregarded in accordance with subsection 130-83(2) of the ITAA 1997.

Cessation time is when employment ceases

82. Where the cessation time relates to the cessation of employment of a participating employee as provided for in subsection 139CB(2), the amount of the discount is included in a participating employee's assessable income pursuant to subsection 139B(3) as the McKinsey option is a qualifying right.

Option disposed within 30 days of cessation time

83. When a McKinsey option is disposed of in an arm's length transaction within 30 days of the cessation time, the discount is calculated by reference to subsection 139CC(3). In accordance with the decision in paragraph 27, the Commissioner accepts that such a disposal has occurred in an arm's length transaction.

84. No consideration is provided by a participating employee to acquire a McKinsey option, therefore the discount will be the amount of consideration received by the employee on disposal of the McKinsey option, pursuant to subsection 139CC(3).

85. As a McKinsey option is a qualifying right and no election is made by a participating employee under section 139E, any capital gain or loss made on disposal is disregarded in accordance with subsection 130-83(2) of the ITAA 1997.

Option not disposed of within 30 days of cessation time

86. Where a McKinsey option is not disposed of in an arm's length transaction within 30 days of the cessation time, the discount is calculated by reference to subsection 139CC(4). This will be the market value of the option at the cessation time less any consideration paid to acquire the option.

87. No consideration is provided by a participating employee to acquire a McKinsey option, therefore the discount will be the market value of the option at cessation time, pursuant to subsection 139CC(4).

88. For CGT purposes, Subdivision 130-D of the ITAA 1997 sets out what happens in relation to shares or rights acquired under an employee share scheme. Where an option is a qualifying right and no section 139E election is made, the first element of the cost base of an option acquired under an employee share scheme is determined pursuant to subsection 130-83(3) of the ITAA 1997. This will be the market value of a McKinsey option at the cessation time.

89. Where a McKinsey option is subsequently disposed of and no section 139E election is made, the disposal will constitute a CGT event A1 as a change of ownership occurs in relation to the option pursuant to subsection 104-10(1) and (2) of the ITAA 1997. The capital gain or loss arising on the CGT event A1 will be the difference between the capital proceeds received and the cost base of the option in accordance with subsection 104-10(4) of the ITAA 1997.

90. Where a McKinsey option is sold to McKinsey at a market value that is determined using the ABV method, Division 116 of the ITAA 1997 determines what will be the capital proceeds from the disposal of the option which is a CGT event A1.

91. Section 116-20 of the ITAA 1997 contains the general rules about capital proceeds and section 116-10 contains modifications to those general rules that may be relevant. Subsection 116-10(2) of the ITAA 1997 is relevant if the event was not a dealing at arm's length and provides a market value substitution rule. Further, subsection 116-30(2) of the ITAA 1997 provides that where the capital proceeds are more or less than the market value, the capital proceeds are replaced with the market value.

92. However, a McKinsey option can only be sold to McKinsey at a market value that is determined using the ABV method which is accepted as being the market value for the purposes of subsection 139FB(1). Therefore, the capital proceeds will be the money received from the sale of the McKinsey option, in accordance with section 116-20 of the ITAA 1997.

Disposal of a share

93. Where a participating employee disposes of a McKinsey share that was acquired as a result of exercising a McKinsey option, the CGT implications of that disposal will depend on whether a participating employee has lodged a section 139E election in relation to the McKinsey option.

Where an election is made under section 139E

94. A participating employee may make an election in accordance with section 139E, that subsection 139B(2) applies for the year of income in relation to each qualifying right. The year of income will be the year that a McKinsey option is acquired.

95. For CGT purposes, Subdivision 130-D of the ITAA 1997 sets out what happens in relation to shares or rights acquired under an employee share scheme.

96. The first element of the cost base of a McKinsey share is determined by reference to item 1 of the table in section 134-1 of the ITAA 1997. This will be the amount paid for the option plus any amount paid to exercise the option. Note 3 to that table further indicates that the rule in item 1 is modified by section 112-15 and subdivision 130-D of the ITAA 1997. This means that what the participating employee paid for an option is its market value as determined under subsection 130-80(2) of the ITAA 1997.

97. The reference to market value in subsection 130-80(2) of the ITAA 1997 further refers to how that is worked out in sections 139FA to 139FF. As explained in paragraphs 57 to 66, the relevant section is section 139FB which provides for the determination of the value of the underlying share for the purpose of calculating the market value of an unlisted right such as a McKinsey option.

98. Where a McKinsey share is subsequently disposed of, the disposal will constitute a CGT event A1 as a change of ownership occurs in relation to the share pursuant to subsection 104-10(1) and (2) of the ITAA 1997. The capital gain or loss arising on the CGT event A1 will be the difference between the capital proceeds received and the cost base of the share in accordance with subsection 104-10(4) of the ITAA 1997.

99. Where a McKinsey share is sold to McKinsey at a market value that is determined using the ABV method, Division 116 of the ITAA 1997 determines what will be the capital proceeds from the disposal of the share which is a CGT event A1.

100. Section 116-20 of the ITAA 1997 contains the general rules about capital proceeds and section 116-10 contains modifications to those general rules that may be relevant. Subsection 116-10(2) is relevant if the event was not a dealing at arm's length and provides a market value substitution rule. Further, subsection 116-30(2) of the

ITAA 1997 provides that where the capital proceeds are more or less than the market value, the capital proceeds are replaced with the market value.

101. However, a McKinsey share can only be sold to McKinsey at a market value that is determined using the ABV method which is accepted as being the market value for the purposes of subsection 139FB(1). Therefore, the capital proceeds will be the money received from the sale of the McKinsey share, in accordance with section 116-20 of the ITAA 1997.

Where no election is made under section 139E

102. As a McKinsey option is a qualifying right, the discount in relation to that option is included in a participating employee's assessable income pursuant to subsection 139B(3) in the year of income in which the cessation time occurs.

103. For the purposes of section 139CB, the cessation time in relation to a share acquired as a result of exercising a McKinsey option, is the time when the option is exercised (para 139CB(1)(d)).

Share disposed of within 30 days of cessation time

104. Where a McKinsey share acquired by a participating employee as a result of exercising an option, is disposed of in an arm's length transaction within 30 days of the cessation time, the discount is included in the employee's assessable income in the year of income that the cessation time occurs pursuant to subsection 139B(3). In accordance with the decision in paragraph 27, the Commissioner accepts that such a disposal has occurred in an arm's length transaction.

105. The amount of the discount to be included in assessable income is calculated in accordance with subsection 139CC(3) and will be the consideration received on disposal of a McKinsey share less the amount paid to exercise a McKinsey option.

106. In accordance with subsection 130-83(2) any capital gain or loss made as a consequence of such a disposal is disregarded.

Share not disposed of within 30 days of cessation time

107. Where a McKinsey share acquired by a participating employee as a result of exercising an option, is not disposed of in an arm's length transaction within 30 days of the cessation time, the discount is included in the employee's assessable income in the year of income that the cessation time occurs, pursuant to subsection 139B(3).

108. The amount of the discount to be included in assessable income is calculated in accordance with subsection 139CC(4) and will be the market value of the share at the cessation time less the amount paid to exercise the McKinsey option.

109. For CGT purposes, where a CGT event A1 does not occur (in relation to a McKinsey share acquired as a result of exercising an option) in an arm's length transaction within 30 days of the cessation time, the first element of the cost base for such a share not sold, is the market value of that share at the cessation time, pursuant to subsection 130-83(3) of the ITAA 1997.

110. The reference to market value in subsection 130-83(3) of the ITAA 1997 further refers to how that is worked out in sections 139FA to 139FF. As explained in paragraphs 57 to 66, the relevant section is section 139FB which provides for the determination of the value of the underlying share for the purpose of calculating the market value of an unlisted right such as a McKinsey option.

111. Where a McKinsey share is subsequently disposed of and no section 139E election was made in relation to the option, the disposal will constitute a CGT event A1 as a change of ownership occurs in relation to the share pursuant to subsection 104-10(1) and (2) of the ITAA 1997. The capital gain or loss arising on the CGT event A1 will be the difference between the capital proceeds received and the cost base of the share in accordance with subsection 104-10(4) of the ITAA 1997.

112. Where a McKinsey share is sold to McKinsey at a market value that is determined using the ABV method, Div 116 of the ITAA 1997 determines what will be the capital proceeds from the disposal of the share which is a CGT event A1.

113. Section 116-20 of the ITAA 1997 contains the general rules about capital proceeds and section 116-10 contains modifications to those general rules that may be relevant. Subsection 116-10(2) is relevant if the event was not a dealing at arm's length and provides a market value substitution rule. Further, subsection 116-30(2) of the ITAA 1997 provides that where the capital proceeds are more or less than the market value, the capital proceeds are replaced with the market value.

114. However, a McKinsey share can only be sold to McKinsey at a market value that is determined using the ABV method which is accepted as being the market value for the purposes of subsection 139FB(1). Therefore, the capital proceeds will be the money received from the sale of the McKinsey share, in accordance with section 116-20 of the ITAA 1997.

Detailed contents list

115. Below is a detailed contents list for this Class Ruling:

Commissioner of Taxation
28 April 2004

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

CR 2001/1; TR 92/1; TR 97/16

Subject references:

- securities valuation
- valuation methods
- employee share schemes & options
- employee share ownership
- banking, finance & securities
- financial instruments
- capital gains tax

Legislative references:

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- ITAA 1936 Div 13A Pt III
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