

TD 2016/D3 - Income tax: in what circumstances does a contractual right, which is subject to the satisfaction of a condition, become a right to acquire a beneficial interest in a share for the purposes of subsection 83A-340(1) of the Income Tax Assessment Act 1997 ?

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This document has been finalised by TD 2016/17.

⚠ There is a Compendium for this document: TD 2016/17EC .



Draft Taxation Determination

Income tax: in what circumstances does a contractual right, which is subject to the satisfaction of a condition, become a right to acquire a beneficial interest in a share for the purposes of subsection 83A-340(1) of the *Income Tax Assessment Act 1997*?

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Ruling

1. Subsection 83A-340(1) of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ applies, where:

- (a) you acquire a right under a contract
- (b) at the time you acquire it, the right is not a right to acquire a beneficial interest in a share
- (c) at a later time, and because a condition in the contract is satisfied, the right 'becomes' another right, and
- (d) at this later time, the right is a right to acquire a beneficial interest in a share ('a right to acquire a share').

¹ All references in this draft Determination are to the ITAA 1997, except where specified.

2. A right that becomes a right to acquire a share when a condition of the contract is satisfied must be enforceable against the other party under the terms of the contract, even if only to the extent of the condition. The relevant condition can be one to be fulfilled by either the employee or the employer. However, the condition to be satisfied must be an essential or required precondition for the right to acquire a share being provided. That is, its satisfaction must directly cause the employee to have a right to acquire a share. This condition is a condition 'precedent to performance'.

3. A right that does not directly become a right to acquire a share when the condition precedent is satisfied, is not an indeterminate right under subsection 83A-340(1). This is the case where that right may eventually lead to, or have a distant causal connection to, the eventual acquisition of a right to acquire a share. A right that leads to, or has a distant causal connection to, the eventual acquisition of a right to acquire a share cannot be said to have 'become' a right to acquire a share.

4. Further, a right that is subject to a condition precedent to the formation of the relevant contract itself is not an indeterminate right for the purposes of section 83A-340.

5. This ruling also applies to section 83A-15 of the *Income Tax (Transitional Provisions) Act 1997* (ITTPA).

Example 1 – No contractual rights created

6. *Yachts Ltd wants to set up a new employee share scheme. The CEO of Yachts Ltd meets with its employees and gives them a presentation on the features of the proposed scheme. After the presentation, the employees receive a general memorandum telling them the total number of prospective shares likely to be on offer. The memorandum also states that the remuneration board of Yachts Ltd needs to give its formal approval before the scheme can commence, and that legal advice on the exact terms of the employee share offer are yet to be finalised with the lawyers.*

7. *As no contractual rights have been created in employees at the time of the presentation or when the general memorandum is sent, nothing has been granted at this time that could be an indeterminate right.*

Example 2 – A right that becomes an indeterminate right

8. *Yachts Ltd has now finalised the terms of its employee share scheme, has obtained remuneration board approval, and the exact terms have been settled with the lawyers. Yachts Ltd intends to implement its employee share scheme in conjunction with its Short Term Incentive Scheme (STIS).*

9. *At the beginning of each financial year, under the STIS, each employee is told the potential incentive they could receive. This time around, the incentives will be a mix of rights to acquire shares in the employee share scheme and cash – at the remuneration board's discretion. The employees receive the incentive only when they have reached specific performance goals and remained with Yachts Ltd for a minimum period. Yachts Ltd determines the incentives by the August after the relevant financial year, and provides them by December in the same year.*

10. *Robbie, a Senior Executive at Yachts Ltd, is advised in July 2016 that she will be entitled to a \$50,000 incentive if she meets specific performance goals. Robbie remains employed by Yachts Ltd and, in August 2017, is advised that she has achieved all of her performance goals. In December 2017, the remuneration board decides that Robbie will receive her \$50,000 incentive as \$10,000 cash and rights to acquire shares worth \$40,000 in Yachts Ltd. Robbie receives the cash and rights in December 2017. Robbie must remain with Yachts Ltd for a further 12 months before she can exercise the rights to acquire shares, and she can obtain the shares.*

11. *In August 2017, once Robbie has satisfied her performance conditions, she has a contractual right to enforce the payment up to \$50,000. She has earned her entitlement to the incentive. It is this right, which later becomes a right to acquire a share, that is the indeterminate right for section 83A-340.*

12. *Accordingly, Robbie acquired her indeterminate right, and therefore the right to acquire a share, in August 2017.*

Note: *Any right that Robbie may have received in July 2016 (when she was advised that she would be entitled to the \$50,000 incentive if she met performance goals) did not directly become a right to acquire a share. Only in August 2017 did a right exist (the indeterminate right) that became a right to acquire a share, at which time Robbie also received something of tangible value.*

Note: *For similar reasons, the earlier creation of rights in July 2016 would not be considered to be a 'fringe benefit' under the Fringe Benefits Tax Assessment Act 1986 (FBTAA). A step in a series of steps having the effect of delivering a:*

- *payment of salary or wages, or*
- *benefit described in paragraphs (h) and (ha) in the exceptions to the definition of 'fringe benefit' in subsection 136(1) of the FBTAA,*

to an employee is not, in itself, a separate benefit provided to the employee with separate taxation consequences.

Example 3 – Rights in employment contracts before the employment commences

13. *Cars Ltd enters into contractual negotiations with a prospective employee for a senior executive director role. In April 2016, Cars Ltd executes an employment contract with Jules. Under the terms of the contract, Jules will commence with Cars Ltd on 1 July 2016. His remuneration will be a cash salary, plus shares and rights to acquire shares in Cars Ltd to the value of \$80,000. However, the grant of shares and rights to Jules is subject to both Jules actually commencing employment, and to shareholder approval. On 1 July 2016, Jules commences employment with Cars Ltd and executes a Share Deed with Cars Ltd. Under this Deed, Cars Ltd agrees, subject to shareholder approval, that it will issue the shares and rights to Jules's family trust. On 1 December 2016, at the AGM, the shareholders approve the issue to Jules. The shares and rights are issued on 12 December 2016.*

14. *Although Jules obtained something of value when he executed the employment agreement in April 2016, he had no right relevant to the later acquisition of the right to acquire a share that could be enforced against Cars Limited until he commenced his employment. It was only then that Jules could enforce any rights that he may have had that related to the rights to acquire shares.*

15. Therefore, Jules's right as at 1 July 2016 (and no earlier) is a right (the indeterminate right) that later becomes a right to acquire a share for section 83A-340, once shareholder approval had been obtained.

Example 4 – Conditions precedent to the grant of rights, and conditions precedent to the exercise of rights

16. Ashley is a manager at Trains Ltd. She has been identified as a candidate for the Trains Ltd employee share scheme. However, she must pass a number of conditions to participate, including:

- a) Ashley must remain employed with Trains Ltd for 12 months, and meet specific performance measures before being eligible to be granted a right to acquire a share.
- b) Once Ashley is eligible, Trains Ltd makes her an offer to acquire a right to acquire a share. Ashley may choose to accept this offer, and pay a small premium to Trains Ltd when she accepts the offer.
- c) However, before Trains Ltd issues rights to acquire shares to Ashley, the Remuneration Board of Trains Ltd must approve the issue (this approval is subject to its complete and unfettered discretion).
- d) If the Remuneration Board exercises its discretion in Ashley's favour, Trains Ltd can issue the rights to acquire shares to Ashley.
- e) If the Remuneration Board does not approve the issue of the rights, Trains Ltd will refund Ashley's premium.

17. Exercise of the rights is subject to further conditions. Ashley will only be able to exercise the rights and take possession of the underlying shares if:

- a) she remains in employment with Trains Ltd for three years
- b) she meets at least 80% of her performance measures, and
- c) Trains Ltd's share price reaches a prescribed value at each annual anniversary leading up to the exercise date.

18. Ashley will lose the rights if these conditions are not fulfilled.

19. Ashley has obtained a right (the indeterminate right) that becomes a right to acquire a share at the time she accepts the offer to acquire a right and pays to Trains Ltd a small premium with the acceptance of the offer. It is at this time that a binding contract has come into existence. Until and unless Ashley accepts the offer and pays the premium, she does not obtain any rights with a sufficiently direct connection with the right to acquire shares such that it can be said they are rights that 'become' a right to acquire shares.

20. Therefore, it is this right that arises on acceptance of the offer and payment of the premium that is a right that later becomes a right to acquire a share for section 83A-340, once the Remuneration Board exercises its discretion in Ashley's favour.

21. The further conditions attached to the exercise of the rights to acquire a share listed in paragraph 17 of this draft Determination are not conditions precedent to obtaining

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the rights themselves. However, these conditions are relevant to determining whether Ashley's rights are subject to a real risk of forfeiture.²

Date of effect

22. When the final Determination is issued, it will apply to schemes begun to be carried on or after 9 September 2015 (the date of withdrawal of Taxation Determination TD 2014/21). For schemes entered into before 9 September 2015, taxpayers may elect to apply Taxation Determination TD 2014/21 or this Determination, whichever produces the more favourable outcome.

Commissioner of Taxation

17 August 2016

² In addition the condition in paragraph 16(c) is considered to be both a condition precedent to obtaining a right to acquire a share and evidence of a real risk of forfeiture in certain circumstances.

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.*

ESS interests

23. Division 83A applies, in part, to ensure that benefits provided to employees³ under employee share schemes are subject to income tax at the employee’s marginal rate.⁴

24. Employee share scheme (ESS) is defined in subsection 83A-10(2) as:

a scheme under which ESS interests in a company are provided to employees, or associates of employees, (including past or prospective employees) of:

- a) the company; or
- b) subsidiaries of the company;

in relation to the employees’ employment.

25. An ‘ESS interest’ in a company, as defined, includes a beneficial interest in a right to acquire a beneficial interest in a share in the company (subsection 83A-10(1)). We refer to this as a ‘right to acquire a share’ in this draft Determination.

Indeterminate rights

26. If a beneficial interest is in a right⁵ that later becomes a right to acquire a share, Division 83A applies as if the right had always been a right to acquire a share (section 83A-340). In certain circumstances, section 83A-25 includes any discount in the relevant employee’s assessable income in the income year the indeterminate right is acquired.

27. In *Davies v. FCT* [2015] FCA 773; 2015 ATC 20-520 (*Davies*), the Federal Court described the requirements of subsection 83A-15(1) of the ITTPA⁶ in the following way (at paragraph 73):

[I]t is evident that ‘right’ in this context cannot be a right to acquire shares; otherwise the provision would be circular. Thus the requirements of subs (1) are three:

- (a) a right, which is not a right to acquire shares [is acquired]...;
- (b) which right [later] becomes another right...;
- (c) that latter right being a right to acquire shares.

28. The original right must be something less than, or other than, a right to acquire shares. However, this right must be capable of becoming a right to acquire a share, and must, in fact, become such a right.

³ If an associate (as defined in section 318 of the *Income Tax Assessment Act 1936*) of the employee acquires an ESS Interest, Division 83A will largely operate as if the ESS Interest had been acquired by the employee themselves section 83A-305.

⁴ Section 83A-5.

⁵ An ‘indeterminate right’.

⁶ Subsection 83A-15(1) of the ITTPA is a transitional provision, drafted in relevantly identical terms to subsection 83A-340(1).

29. In *Davies*, the taxpayer held contractual rights to acquire shares and rights to shares subject to shareholder approval. The Federal Court observed (at paragraph 74):

The contingent right to acquire shares is not itself a right to acquire shares...On satisfaction of the condition precedent the nature of that right changes so that it becomes a right to acquire shares.

30. The Commissioner argued that, although the terms of such a conditional right may be set out in the relevant contract or instrument, the right does not exist until the contingency is satisfied. In response, the Federal Court further stated (at paragraph 81):

I should think it a very unsatisfactory state of affairs if I were required to accede to this contention and to find that ... [the] rights exhibited behaviour normally only observed in quantum mechanics. Fortunately, this is not necessary. Conditions precedent can be read either as conditions which must be satisfied before a contract comes into existence at all or as not affecting the existence of the contract but instead conditioning only performance of the obligations already arising under it. Generally, there is a preference for construing such conditions in the second way, that is to say, as going to performance rather than formation: *Perri v. Coolangatta Investments Pty Ltd* (1982) 149 CLR 537 at 552 ('...unless the contract as a whole plainly compels this conclusion' [that it goes to formation]; see also 541 and 545) ('*Perri*').

Conditions precedent to performance

31. To be a beneficial interest in a right within the meaning of paragraph 83A-340(1)(a), the beneficial interest must be a conditional contractual right, within an existing contract (subject to a condition precedent to performance), and not a right subject to a condition precedent to the formation of that contract.

32. There is a fundamental difference between rights where an agreement is to be formed only after certain conditions are satisfied (conditions precedent to formation of the contract), and those rights obtained once a contract is formed, and conditions must be satisfied before some terms within that contract are performed (conditions precedent to performance of the contract, once formed).⁷

33. An examination of the precise terms and surrounding circumstances may indicate that a particular condition is precedent to the formation of a contract, rather than to the performance of its obligations (see, for example, *Roach v. Bickle* (1915) 20 CLR 663).

'Becomes another right'

34. Under paragraph 83A-340(1)(b), a contractual right must be capable of 'becoming' a right to acquire a share. A contractual right subject to a condition precedent to performance may do this only where satisfying the condition⁸ is an essential precondition to the taxpayer acquiring the right to acquire a share.

35. In *Fowler v. FCT* [2013] FCAFC 69; 2013 ATC 20-398; (2013) 92 ATR 595 (*Fowler*), Gordon J held, in relation to a right conditional upon shareholder approval to acquire options over shares (at paragraphs 156-157):

156. ... Mr Fowler enjoyed some rights in respect of the Options. ...[T]he rights Mr Fowler enjoyed in respect of the Options prior to shareholder approval were limited to the relief

⁷ *Perri v. Coolangatta Investments Pty Ltd* (1982) 149 CLR 537 per Mason J at 551.

⁸ Conditions precedent can include those required to be fulfilled by both an employer and/or employee.

available to him in equity. ... Mr Fowler merely had the right to insist that Nexus put the issue of Options to him to its shareholders for their approval. ...

157. ... Mr Fowler's conditional right to the Options ... did not create an equitable interest in either the Options or the shares the subject of the Option (which were...yet to be issued). It is not possible to have a beneficial interest in future property : *Norman v. Federal Commissioner of Taxation* (1963) 109 CLR 9 at 16 and 24; *Federal Commissioner of Taxation v. Everett* (1980) 143 CLR 440 at 450-451.

36. The acquisition of a beneficial interest in such a right (that is, a right that is less than an actual right to acquire an interest in a share) satisfies the first condition in paragraph 83A-340(1)(a).

37. A conditional right is an indeterminate right, to which section 83A-340 applies, if satisfaction of the condition **directly** causes the right to acquire a share to vest absolutely in the taxpayer.⁹

38. Division 83A does not bring to tax all rights that have a distant causal connection to shares or rights to acquire shares. In *Fowler*, Besanko J described the possible steps that might occur between the formation of an enforceable contract and the issue of shares, at paragraph 87:

... After the contract there may be a condition precedent to performance of the obligation to grant or issue options. That condition may or may not be met. If met, the options are granted or issued. There may be some other act involved at this point or later such as the issue of option certificated or entering of the details of the grant of options on the company's register under section 170 of the Corporations Act 2001 (Clth) but those matters are of no consequence for present purposes... In the case of an employee share scheme situation the conditions may include matters such as continued employment with the company at certain dates, or the achievement by the employee of performance targets, again at certain dates. The important point is that those conditions may not be met and therefore shares may never be acquired. If the conditions are met and the options exercised then the shares are actually acquired.

39. Only binding rights arising upon contract formation:

- a) that are subject to a condition precedent to performance under that contract, and
- b) that, upon satisfaction of the condition, directly become rights to acquire shares,

are indeterminate rights under subsection 83A-340(1). A distant causal connection between a right and the ultimate receipt of a right to acquire a share is insufficient for section 83A-340.

40. There may be subsequent and further conditions attached to exercising or forfeiting the right to acquire a share. These have no bearing on whether the rights become rights to acquire a share for the purposes of section 83A-340. However, these further conditions are relevant to determining whether the rights, once they have become a right to acquire a share, are subject to a real risk of forfeiture for the purposes of section 83A-105.

⁹ As a matter of fact, the antecedent conditional right (*Fowler* at 160 - 161, per Gordon J) and the satisfaction of that condition, must be essential preconditions (*Fowler* at 94, per Besanko J) to the vesting of the right in the taxpayer to be said to be one that may 'become' a right to acquire a share for the purposes of the second condition in paragraph 83A-340(1)(b).

Appendix 2 – Your comments

41. You are invited to comment on this draft Determination including the proposed date of effect. Please forward your comments to the contact officer by the due date.

42. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- a) provide responses to persons providing comments, and
- b) be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: 16 September 2016
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References

Previous draft:

Not previously issued as a draft

- ITAA 1997 83A-340(1)(a)
- ITAA 1997 83A-340(1)(b)
- IT(TP)A 1997
- IT(TP)A 1997 83A-15
- IT(TP)A 1997 83A-15(1)

Previous Rulings/Determinations:

TD 2014/21

Legislative references:

- ITAA 1936
- ITAA 1936 318
- ITAA 1997
- ITAA 1997 Div 83A
- ITAA 1997 83A-5
- ITAA 1997 83A-10(1)
- ITAA 1997 83A-10(2)
- ITAA 1997 83A-25
- ITAA 1997 83A-105
- ITAA 1997 83A-305
- ITAA 1997 83A-340
- ITAA 1997 83A-340(1)

Cases relied on:

- Davies v. FCT [2015] FCA 773; 2015 ATC 20-520; (2015) 234 FCR 93
- Fowler v. FCT [2013] FCAFC 69; 2013 ATC 20-398; (2013) 92 ATR 595; (2013) 212 FCR 149
- Perri v. Coolangatta Investments Pty Ltd (1982) 149 CLR 537; (1982) 41 ALR 441; [1982] HCA 29
- Roach v. Bickle (1915) 20 CLR 663; [1915] HCA 80

ATO references

NO: 1-7U7ZYPU

ISSN: 2205-6211

BSL: PGH

ATOlaw topic: Income tax ~~ Assessable income ~~ Employee share schemes ~~ Other

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