Tax system quirk could hit executive hip pockets

After wild swings in the market, some executives may find their tax liability for the financial year exceeds the current value of the shares they received under employee share schemes. ILLUSTRATION: KARL HILZINGER

Opinion

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Dazed and Confused was a catchy title for the cult classic film of the 1990s and, in all likelihood, an equally apt description of the response from many ASX-listed company executives on receiving their end-of-financial year employee share scheme tax statements.

While ESS reporting is usually an uneventful occurrence on the corporate calendar, the sharemarket's roller-coaster ride of the past 12 months created the perfect storm for self-inflicted, share schemes tax damage.

The rules require companies to report the taxable amount of ESS income from taxing points triggered in the last financial year. If performance rights vest and convert into shares, for example, the employee will generally be taxed on the market value of the shares on the date the shares are delivered to them.

The company must report the taxable amount to participants by July 14 and to the Australian Taxation Office by August 14. The Tax Office data matches the amount reported by the employer with the amount included in the individual's tax return, and any discrepancies throw up a red flag.

Foreign jurisdictions, including the UK, require employers who provide share scheme interests to pay the tax on the employee's behalf, which is generally funded by "sell to cover" arrangements.

But Australia's ESS reporting rules represent an oddity in the tax system, whereby employees are expected to entirely self-assess their ESS income (unlike payments of salary, from which PAYG amounts are withheld and remitted to the ATO on the employee's behalf and fringe benefits, which are taxable to the employer).

The self-assessment mechanism puts significant pressure on employees to make sure they have sufficient cash to pay their tax liability, which often hits home many months later.

Well-advised employees at the executive level will often choose to sell a sufficient number of their shares at the taxing point to ensure they have enough cash to pay the tax bill. For example, if an executive holds 1000 performance rights that vest when the share price is $10, their ESS income (taxed at the executive's marginal rate) would be $10,000.

An executive on the top rate would need to sell just under half their shares to fund the tax bill.

If the share price goes up, the individual would benefit from not having sold any of their shares at the taxing point because they would be able to cover their tax bill by offloading a smaller number of shares down the track.

In a plummeting market, however, the executive who chose not to sell some of their shares at the taxing point could be caught out.

Revisiting the above example, if the share price fell to 20¢, the employee's tax liability would still be $4700, while the shares would only be worth $2000.

Many listed companies that rode the COVID-19 bull run would have had vestings of long-term incentive rights in August-October 2021 at the peak of the market.

If those share rights converted into shares at that time, large tax liabilities would most likely have crystallised.

With the savage falls in listed stocks over the last six months (particularly in the tech sector), C-suiters who held on to all of their shares may now find themselves in a position where their tax liability for the financial year ended June 30 exceeds the current value of the shares they got.

In a market abuzz with M&A activity and extended blackout periods, executives may have been unable to sell their shares for extended periods of time, all the while watching the share price tumble.

Worse still, the tax liability, once triggered, is irreversible.

A capital loss on the disposal of the shares, while a small consolation prize, would still leave our executive nursing a black eye and perhaps wondering why they didn't just opt for a cash bonus.

As board remuneration committees ponder remuneration structures for the next AGM season, the damage inflicted over the first half of 2022 will weigh heavily.

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