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ESS – Real risk of forfeiture

Sometimes we consider employee share scheme interests (ESS interests), that is – shares, stapled securities and rights to acquire shares and stapled securities – to be at a real risk of forfeiture.

This applies only to ESS interests acquired under an employee share scheme (ESS) after 30 June 2009.

Deferred taxing point

Generally, a discount to the market value of an ESS interest is taxed on acquisition of the ESS interest.

However, when there is a real risk that the benefits of an ESS interest may never be realised because the ESS interest may be forfeited, the tax will be deferred until a deferred taxing point.

The 'real risk of forfeiture' test is relevant in determining the deferred taxing point.

For the tax to be deferred, the ESS and the employee must also meet certain conditions.

See also:

- [Employees \(/General/Employee-share-schemes/Employees/\)](#)

Real risk of forfeiture test

Whether or not a real risk of forfeiture is present will depend on the facts and circumstances of each scheme and the individual circumstances of the employee.

An ESS interest acquired by an employee is at real risk of forfeiture if a reasonable person would consider that there is a real risk that the employee may forfeit or lose the ESS interest, other than by intentionally taking no action to realise the benefit.

The meaning of 'real' is something more than a mere possibility. An ESS interest will not be at real risk of forfeiture if a reasonable person would disregard the risk as highly unlikely to occur or as nothing more than a rare eventuality or possibility.

Real risks of forfeiture in a scheme may include conditions where retention of the ESS interests is subject to:

- performance hurdles
- a minimum term of employment.

There is no real risk of forfeiture where a scheme simply includes a condition which:

- restricts an employee from disposing of an ESS interest for a specified time
- allows an employee to request that the ESS interest be forfeited
- provides for an employee to forfeit an ESS interest if they are dismissed for fraud or gross misconduct.

The examples in this document consider only the real risk of forfeiture. The examples meet all other conditions necessary for a scheme to qualify for tax deferral.

Example 1: Fraud or gross misconduct, no real risk

Ted works for Bear Ltd and is granted shares in Bear Ltd under an ESS.

Ted will forfeit the shares if he is dismissed for fraud or gross misconduct within the next three years.

The ESS does not include any other conditions under which Ted could forfeit his shares.

Ted's shares are not considered to be at real risk of forfeiture.

There is no real risk of forfeiture where we consider the condition to be contrived.

Factors which might suggest a condition is contrived include:

- a short minimum term of employment combined with a long disposal restriction period
- giving the plan operator an overriding discretion to vest ESS interests where performance hurdles are not met, and the operator exercises that discretion on a routine basis.

Performance hurdles

Whether performance hurdles constitute a real risk of forfeiture will depend on the facts and circumstances in each case.

Where an employee is granted ESS interests that are subject to forfeiture if the company does not achieve specified performance targets, such as an increase in sales over a specified period relative to itself, we will consider the facts and circumstances to determine whether the ESS interests are, at the time of grant, at real risk of forfeiture. We must consider the likelihood of the company meeting its targets.

Example 2: Performance hurdle sales target, no real risk

Tania works for South Ltd and is granted rights to acquire shares in South Ltd under an ESS.

Under the conditions of the scheme, Tania's rights will lapse if South Ltd's current year sales do not exceed last year's sales.

The ESS does not have a minimum employment requirement.

South Ltd has increased its sales by more than 10% in each of the preceding five years and has recently taken over a major competitor.

In this case, we consider that a reasonable person might consider that the rights acquired by Tania were not at a real risk of forfeiture.

Example 3: Total shareholder return, real risk

Anne works for Bob Ltd and is granted rights to acquire shares in Bob Ltd under an ESS.

Under the conditions of the scheme Anne's rights will lapse if, over the next three years, Bob Ltd's total shareholder return (TSR), when compared to the TSR of companies in a specified peer group, is not in the top 50%.

Bob Ltd has a history of regularly achieving a high TSR relative to its peer group.

Even though Bob Ltd has regularly achieved a high TSR relative to its peer group, we consider in this case that a reasonable person might consider the rights acquired by Anne to be at real risk of forfeiture, considering that this performance hurdle is based on the performance of peers.

Minimum term of employment

An ESS may provide for ESS interests to be forfeited if the employee doesn't complete a minimum term of employment (forfeiture period).

We accept that there will be a real risk of forfeiture where the minimum term of employment is at least six months and the maximum deferral is no more than three years; or where the minimum term of employment is at least 12 months.

For ESS interests acquired outside these parameters, we will consider all the facts and circumstances to determine whether they are at a real risk of forfeiture.

Example 4: Forfeiture on cessation of employment, real risk

Steve works for Ceiling Ltd and is granted rights to acquire shares in Ceiling Ltd under an ESS.

Under the conditions of the scheme Steve's rights will lapse if he ceases employment with Ceiling Ltd within the next 12 months.

Steve's rights to acquire shares in Ceiling Ltd are accepted as being at a real risk of forfeiture.

Example 5: Forfeiture after vesting due to choice, no real risk

Aimee works for Skydiving Ltd and is granted rights to acquire shares in Skydiving Ltd under an ESS.

Under the conditions of the scheme Aimee must remain employed with Skydiving Ltd for two years before the rights can be exercised. After the two-year period, the rights can be exercised for a period of four years. However, Aimee's rights will lapse:

- if she ceases employment before exercising the rights
- at the end of the four-year period (if the rights are not exercised).

In this case we consider that at the time of acquisition the rights are at a real risk of forfeiture.

However, after two years Aimee's rights will no longer be at a real risk of forfeiture. We consider that any risk of Aimee losing her rights after the two-year period will be due to her choosing not to take action to exercise her rights.

Example 6: Forfeiture on cessation of employment and monthly vesting, real risk

Alastair works for Camera Ltd and is granted rights to acquire shares in Camera Ltd under an ESS.

Under the conditions of the scheme, rights will vest progressively at monthly intervals over a four year period. Upon vesting, Camera Ltd will issue shares to Alastair. If Alastair ceases employment with Camera Ltd, any unvested rights will lapse.

The scheme operates to attract and retain the best employees while promoting the success of the company. Camera Ltd's strict insider trading policy allows employees to sell their shares, but only during quarterly trading windows.

Although the required period of employment until the first vesting date is only one month, because Alastair is able to dispose of his vested shares during quarterly trading windows (i.e. the disposal restriction period is commensurate with the vesting period) we consider that a reasonable person would accept that at the time of acquisition, Alastair's rights are at a real risk of forfeiture.

Example 7: Early vesting on takeover, real risk

Jadzia works for Red Ltd and is granted rights to acquire shares in Red Ltd under an ESS.

Under the conditions of the scheme Jadzia will forfeit her rights if she ceases employment with Red Ltd within the next two years.

As Jadzia must complete a minimum term of employment, the rights are at a real risk of forfeiture.

However, under the conditions of the scheme Red Ltd has a discretion to vest all or some of Jadzia's rights in the event of a takeover bid for or a change in control of Red Ltd.

Red Ltd is not subject to a takeover bid at the time the rights are granted.

In this case we still consider that at the time of acquisition the rights are at a real risk of forfeiture, despite Red Ltd's discretion to vest the rights.

A takeover bid is an event beyond Jadzia's control. If, for example, a bid occurred shortly after Jadzia's acquisition of the rights, Red Ltd could decide not to vest some or all of the rights.

Minimum term of employment and good leaver conditions

An ESS that provides for ESS interests to be forfeited if an employee does not complete a minimum term of employment may contain 'good leaver' conditions that allow employees to retain their interests if they cease employment during the forfeiture period.

Where a scheme contains good leaver conditions that allow ESS interests to be retained for example, in the event of death, invalidity or bona fide redundancy, we accept that the ESS interests are at a real risk of forfeiture. However, where the scheme routinely allows employees to retain their ESS interests regardless of their reason for ceasing employment, we consider a reasonable person would not accept that the ESS interests are at a real risk of forfeiture.

Example 8: Forfeiture on cessation of employment, real risk where a good leaver leaves for reasons beyond their control

Hudson works for Vine Ltd and is granted rights to acquire shares in Vine Ltd under an ESS.

Under the conditions of the scheme Hudson will forfeit his rights if he ceases employment within three years, subject to good leaver conditions.

The scheme's good leaver conditions allow employees to retain their rights if they cease employment with Vine Ltd for reasons beyond their control, such as invalidity or redundancy.

The scheme is not operated so as to routinely allow employees to retain their rights regardless of their reason for ceasing employment.

Hudson's rights are accepted as being at a real risk of forfeiture.

Minimum term of employment and retirement

Good leaver conditions in an ESS may allow employees to retain ESS interests if they cease employment to retire from the workforce permanently during the forfeiture period. Whether ESS interests acquired under an ESS with good leaver conditions are at a real risk of forfeiture will depend on the facts and circumstances, including how the ESS is operated and the employee's personal circumstances.

Example 9: Good leaver provisions and retirement, no real risk

Linda works for Central Ltd and is granted rights to acquire shares in Central Ltd under an ESS.

Before Linda acquired the rights, she advised her employer that she would be retiring and permanently leaving the workforce within the next year, when she turned 60 years old.

Under the conditions of the scheme Linda will, subject to good leaver conditions, forfeit her rights if she ceases employment within two years (the forfeiture period).

The scheme contains no other forfeiture conditions.

The scheme's good leaver condition allows employees 55 years old and older who cease employment during the forfeiture period to retain their rights if they are permanently leaving the workforce to retire.

In this case we consider that a reasonable person would accept that, due to Linda's clear intention to retire during the forfeiture period, the rights acquired by Linda were not at a real risk of forfeiture.

Example 10: Good leaver provisions and retirement, real risk

Sienna works for North Ltd and is granted rights to acquire shares in North Ltd under an ESS.

Under the conditions of the scheme Sienna will forfeit her rights if she ceases employment within the next two years, subject to good leaver conditions.

The scheme's good leaver condition allows employees 55 years old and older who cease employment during the forfeiture period to retain their rights if they are retiring permanently.

The way the scheme is operated, employees can retain their shares only if the employer is satisfied that they are retiring permanently.

The scheme contains no other forfeiture conditions.

At the time the rights are acquired Sienna is 55 years old and does not intend to retire during the forfeiture period.

In this case we consider that a reasonable person would accept that at the time of acquisition, Sienna's rights are at a real risk of forfeiture.

Example 11: Retirement pro-rata clause, real risk

Brenton works for Gamer Ltd and is granted rights to acquire 300 shares in Gamer Ltd under an ESS.

Under the conditions of the scheme one-third of the rights vest each year and an employee will forfeit unvested rights if they are no longer employed by Gamer Ltd at the end of each particular year.

The scheme contains a good leaver condition that permits Gamer Ltd to allow its employees, who retire during the three-year forfeiture period, to retain a portion of their unvested rights on a pro-rata basis for each day they are employed during the year.

Gamer Ltd does not have a minimum retirement age, but the discretion is exercised such that only employees known to be retiring permanently are able to retain a portion of their unvested rights.

At the time Brenton receives the rights, he is 52 years old and not intending to retire from the workforce permanently. As such, we consider that all 300 of Brenton's rights are at a real risk of forfeiture.

If before the rights were acquired, Brenton advised his employer that he would be retiring and permanently leaving the workforce in 12 months time, 200 of the rights would be at real risk of forfeiture and 100 rights would not be at real risk of forfeiture.

ESS with both service and performance conditions

Both performance and service conditions, such as a minimum term of employment, can be taken into account to determine whether there is a real risk of forfeiture on acquisition of an ESS interest.

Where the service conditions are sufficient to satisfy the real risk of forfeiture test at the time of acquisition, it is not necessary to consider whether the performance conditions also satisfy the test.

However, where there is some doubt about service conditions alone satisfying the real risk of forfeiture test, we will also consider whether the performance conditions satisfy the test.

ESS with only a portion subject to a real risk

An employee may receive ESS interests where only a portion of the ESS interests are subject to a real risk of forfeiture. Only the portion that is at real risk will be eligible for tax deferral.

Example 12: Performance hurdles over a portion of ESS interests

James works for Douglas Ltd and is granted rights to acquire 1,000 shares in Douglas Ltd under an ESS.

Under the conditions of the scheme James will receive 1,000 shares in three years time if Douglas Ltd's total shareholder return (TSR) over the three-year period, when compared to the TSR of companies in a specified peer group, is in the top 50% of its peer group. However, where the TSR is not within the top 50%, James will receive 600 shares.

The ESS does not contain any other forfeiture conditions, including a minimum term of employment.

In this case we consider that at the time of acquisition only 400 of the rights are at a real risk of forfeiture since James will receive 600 shares in three years time regardless of Douglas Ltd's performance.

See also:

- [Employees \(/General/Employee-share-schemes/Employees/\)](#)

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