Submission to the Parliamentary Committee Inquiry into the Tax Treatment of Employee Share Schemes with particular reference to the effectiveness of the 2015 Employee Share Scheme (ESS) changes.

Relevance to Terms of Reference:

This submission relates in particular to the following term of reference:

"whether the current tax treatment of ESS remains relevant to start-up companies and whether any changes are appropriate to ensure the taxation treatment remains relevant."

This submission relates to an actual matter involving an actual taxpayer and was the subject of an unsuccessful Private Ruling application.

Case Details:

Company A was incorporated on 21/12/2011 to research and develop the technology for converting used rubber tyres into saleable output product of carbon and related by-products.

On the same date Company A entered into a Binding Agreement with Company B to provide the services of Company B's director to undertake the duties of a Chief Operations Officer (COO) in relation to the business of company A on the terms and conditions set out in

a schedule of the Agreement which included the provision of fund raising services to obtain capital and funding for Company A.

Consultancy fees were agreed requiring Company A to pay company B a monthly consultancy fee of $24,425 (plus GST).

During the financial year 2012 and part of 2013, invoices rendered to Company A by Company B were duly honored and paid in accordance with the agreement.

Subsequent invoices amounting to a total of $765,466.20 rendered through to 30 June 2015 were not paid due to Company A having insufficient funds.

On 22nd September 2015 Company A's Board resolved to issue 3,827,331 shares at 20 cents fully paid to Company B in settlement of the COO's remuneration in arrears.

Company A satisfied the requirements to qualify as a start-up company under S83A of the 1997 Tax Act and Company B or the COO expected to be assessed under the ESS concessions available under the Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015.

As there was no market available for the shares due to Company A being an unlisted public company and also conditions placed on the share issue that required the shares to be held until the company was able to proceed with an IPO, the expectation was that the taxing point would be deferred until such time as the shares were released from escrow.

It is understood that S83A-5(a) being the objects of Division 83A is to ensure that the benefits provided to ***employees*** under the employee share schemes are subject to income tax at the employee's marginal tax rates under the income tax law. It was also expected that the taxing point on employee shares would be deferred until the shares were marketable or freed from escrow.

It was also understood that the three conditions set out at Section 83A-10 for a grant of shares to be under an employee share scheme were satisfied viz:

- The grant of the shares must be EES interests
- There must be an employment-like relationship – specifically, the grant of ESS interests must be in respect of the employee's employment with the company that the shares are in.
- The ESS interests may be granted to the employee or to their ***associate.*** – in this case Company B

S83A-305 deals with acquisitions (of shares) by associates and specifically states that if an associate of an individual acquires an ESS interest ***in relation to the individual's employment*** then for the purposes of Division 83A, the interest is treated as being acquired by the individual (instead of the associate).

Outcome of Private Ruling

Irrespective of whether the issued shares are taxed to Company B or the COO being the sole director of Company B the result of the Private Ruling Application was to rule that:

"Pursuant to s83A-25 (1) your assessable income in the ***income year in which you acquire the ESS interest*** includes the value of the employment services (including any discount if applicable)."

This resulted in the amount of $765,466 being assessable to either Company B or the COO depending upon whether or not Company B qualifies under Division 83A as an associate.

This is an untenable situation as the shareholder cannot sell the shares in order to release funds which could be used to fund the tax liability at a company tax rate of 30% amounting to $229,639.80.

Furthermore as with many start-up companies, they end up unable to list on a stock exchange and in extreme cases the shares issued some years earlier may prove to be worthless leaving the "employee" effectively devoid of payment for the services rendered and having paid tax on income that ultimately had no value.

If Company A had issued either share rights or share options my understanding is the taxing point would be deferred until the income year in which the rights or options vested and were exercised. In this case the recipient would be able to sell the shares as a market would exist when they vested and would therefor release funds to enable the tax liability to be cash flowed.

In my view this is an outcome that was hopefully not intended when the changes to the Employee Share Scheme were legislated in 2015. The legislation therefore needs to be amended to also include the issue of shares in return for services rendered by employees and consultants.

5.

[redacted]