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SMSFs must tread carefully when dealing with employee share schemes interests

dbalawyers.com.au/ato/smsfs-must-tread-carefully-dealing-employee-share-schemes-interests/

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The idea of acquiring shares from employee share schemes ('ESS') in an self managed superannuation fund ('SMSF') can be attractive for many reasons, but SMSF trustees have to be mindful of the in-house asset and the related party acquisition rules.

Broadly, a company can via an ESS provide employees the opportunity to acquire its shares or options. Generally the upside is that employees are able to obtain more favourable terms or prices and lower transaction costs compared to other investors. However, the usual caveat is that interests acquired under an ESS are typically subject to restrictions on vesting and sale.

In addition, from a tax viewpoint, a person who acquires ESS interests may be eligible for special tax concessions, such as the ability to defer the taxing point for up to 15 years. Generally the ability to defer the taxing point *applies* where there is a real risk that the employee will forfeit or lose their interest under the ESS, eg, if the employee is not meeting performance targets or cease employment with the company (s 83A-115 of the Income Tax Assessment Act 1997 (Cth)).

Can an SMSF trustee acquire ESS shares from an employee?

Broadly, an ESS interest can only be acquired by an SMSF where it is:

1. a publicly listed share acquired at market value; or
2. less 5% of the total market value of the SMSF's assets.

Under some ESS arrangements, the employee can elect to have an associate (eg, a spouse, family company, family trust or SMSF trustee) take up their ESS interests. This may result in, under certain ESS plans, the employee foregoing their entitlement to an ESS interest to allow an associate to take it up.

Further, under some ESS arrangements, if the employee elects their SMSF, from a legal perspective, the SMSF trustee may be acquiring the ESS interest indirectly from the employee. For superannuation law, the employee would invariably be a related party of the SMSF. Unfortunately, SMSFs are broadly prohibited from acquiring assets from members and related parties, unless the value of the ESS interest qualifies as an in-house asset and the value of the fund's in-house asset is less than 5% of the total market value of the SMSF's assets (s 66 of the *Superannuation Industry (Supervision) Act 1993* (Cth)).

ESS interest acquired by SMSF trustee at less than market value or for no consideration

If ESS shares are acquired by an SMSF trustee at less than market value or for no consideration, the ATO will treat the discount as a personal contribution to the SMSF by the employee (ie, generally a non-concessional, in-specie contribution). The ATO's website addresses the following situation:

If the scheme says the member can nominate their SMSF to receive shares or options and the trustee of the SMSF pays no consideration or less than the market value consideration for the shares or share options, the acquisitions by the SMSF result in super contributions if the contributions are made for the purpose of benefitting one or more particular members of the fund, or all of the members in general.

Further, the ATO, in TR 2010/1, state that where the capital of the fund increases and the purpose is to benefit a member or members then a contribution arises.

Consider the following example:

Rufus is an employee of SHINRA LTD. SHINRA has an ESS for its employees. SHINRA offers the ESS shares at a 25% discount and no brokerage fee. Due to his performance, SHINRA offers Rufus 100 shares. Rufus takes up the offer and nominates his SMSF's trustee to receive the 100 shares.

SHINRA shares on the date of transfer have a market value of $2.

When the shares are contributed to Rufus' SMSF, the shares are treated as being acquired at $2 each ($2 x 100 shares, in total $400), ie, the market value of the shares.

In the relevant financial year's tax return, Rufus chooses not to defer the taxing point (since he sees more upside paying the tax upfront). Hence, $300 ($1.50 x 100 shares) would be included in Rufus' assessable income for the relevant year. Whereas, Rufus' SMSF trustee would record the contribution of his ESS interest (worth $400) as a non-concessional contribution.

Acquiring an ESS interest at market value is crucial since an acquisition of an asset below market value can result in any dividends or capital gain in respect of the shares being taxed as non-arm's length income. The tax rate in respect of non-arm's length income for FY2018 is 45% plus the applicable levies (s 26 of the *Income Tax Rates Act 1986* (Cth)).

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