

Regulatory Impact Statement

Simplifying the collection of tax on employee share schemes

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to simplify the collection of tax on employment income an employee receives under an employee share scheme (ESS). Specifically, it explores the idea of changing the way income tax on employee share scheme benefits is collected.

None of the options discussed in this RIS are intended to alter the recognition or valuation of tax payable on an ESS benefit or change employers' ability to deduct for income tax purposes the value of any ESS benefits provided to employees. These issues are part of a separate project that is on the Government's tax policy work programme.

The policy proposals in this RIS have been advanced ahead of this other project on employee share schemes so that it can be included as part of a package of measures in a June 2015 taxation bill that demonstrates the Government's commitment to delivering tangible change through Inland Revenue's Business Transformation programme. These measures had to be fiscally neutral, straightforward to administer and implement, and not pre-empt any wider policy reforms scheduled for later stages of Inland Revenue's Business Transformation programme.

Inland Revenue released an issues paper in April 2015 entitled *Simplifying the collection of tax on employee share schemes*. The issues paper acknowledged that a number of problems exist with the way that tax is collected from benefits received under an employee share scheme. It sought comment on our definition of the problem with the current system, three options to allow employers to account for tax on employee share scheme benefits on their employees' behalf, and whether the collection mechanism should be compulsory or apply at employers' election.

A total of 17 submissions were received on the issues paper. Submissions broadly agreed with our problem definition and the reasons for considering legislative change to shift the point at which tax is collected on ESS benefits. The majority of submissions were supportive of the idea of shifting the obligation to collect tax on ESS benefits to the employer. However, this support was conditional on:

- Employers having the choice of collecting tax on ESS benefits; or
- In the alternative, if employers did not have any choice, existing schemes should be outside the scope of any change – that is, employers with existing schemes should be outside the scope of any obligation to collect tax unless they chose to opt in.

If source taxation applied to ESS benefits, submissions expressed a strong preference that the PAYE system be used, rather than the FBT system or a separate withholding tax system.

Submissions also recognised that if employers had the choice of whether to collect tax it would be reasonable for them to provide information to Inland Revenue about the employees who received an ESS benefit. However, submissions varied on what information should be disclosed.

As a result of submissions and the need to improve the overall efficiency of collecting tax on ESS benefits, our preferred option is to use the PAYE system to collect tax and for employers to have the choice to withhold tax. Allowing the collection of tax to be optional permits employers to evaluate the tax benefits and costs so that the employer's obligation to collect tax using the PAYE rules applies when, in the employer's view, it is most efficient to do so.

Inland Revenue considers that its information requirements can be met if the value of any ESS benefits is disclosed using the employer monthly schedule (EMS). Including the value of these benefits in the EMS would not automatically create an obligation to withhold tax. We recognise that this disclosure requirement may increase compliance costs for some employers in terms of valuation and funding the payment of tax. These costs, however, are currently incurred by employees.

The Treasury and the Accident Compensation Corporation were involved in the policy development of the recommended proposal and agree with conclusions reached.

Inland Revenue does not hold comprehensive information on the number of employee share schemes offered in New Zealand or the number of employees involved in such schemes. We are aware that large corporate taxpayers commonly use these schemes as part of their remuneration strategies. Our analysis has been based on comments received from submissions on the officials' issues paper *Simplifying the collection of tax on employee share schemes*, the expected outcomes under the options considered and contrasted against the status quo, and the current tax law that applies to employment income in the form of ESS benefits.

None of the policy options restrict market competition, impair property rights, reduce the incentive for businesses to provide these schemes, or override fundamental common law principles.

There are no other significant constraints, caveat or uncertainties concerning the analysis undertaken.



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STATUS QUO AND PROBLEM DEFINITION

Current policy and law

1. Collecting tax at the source of income earned by a taxpayer is an important feature of modern tax systems. Collection at source ensures there is more accurate reporting of income and reduced collection risk. Collection at source also gives the Government the ability to leverage the tax system to provide social policy outcomes – for example, the various social policy programmes that rely on accurate reporting of individual and household incomes such as child support, student loans and Working for Families tax credits.

2. Benefits¹ provided to an employee under an employee share scheme (ESS) are “employment income” under the Income Tax Act 2007. Unlike most employment income or benefits, such as salary and wages or a use of a company car, however, it is not currently subject to tax at source under either the Pay As You Earn (PAYE) or Fringe Benefits Tax (FBT) rules. This means that employee recipients of ESS benefits must file an individual tax return to account for the ESS benefits as income and pay the tax on those benefits themselves.

Current practice

3. The collection of tax on ESS benefits has not been well understood to date and a number of companies have been accounting for ESS benefits through the PAYE system despite the law not providing for this. To clarify the correct treatment, Inland Revenue released a Large Enterprises Update in November 2013 which advised employers that ESS benefits are not subject to either PAYE or FBT so should not be included in their employer monthly schedule or FBT return. Instead they were advised that any employee receiving an ESS benefit must file an IR 3 tax return for the income year in which they receive it.

4. Following this Large Enterprises Update, stakeholders, including the Corporate Taxpayers Group have requested as a high priority a legislative amendment to permit employers to account for tax on ESS benefits at source, preferably through the PAYE system.

The problem

5. The current collection mechanism requiring an employee to file a return and account for the tax on ESS benefits imposes compliance costs on taxpayers and administrative costs on Inland Revenue. As no tax is deducted at source, the obligation to return the ESS benefit as income may be unfamiliar territory for employees who may not be used to not filing tax returns with Inland Revenue. Further complications can arise if the employee needs to sell shares to meet any tax obligations and, if the obligation is large enough (the residual income

¹ The “benefit” under an ESS is, in the case of an acquisition of shares, the amount by which the value of the shares when they were acquired is more than the amount paid or payable for them. Share options provided to employees are generally not taxed until they are exercised, at which time the tax treatment in the previous sentence applies.

tax is \$2,500 or more)² the employee could find themselves subject to the provisional tax rules and use of money interest (UOMI).

6. These tax compliance costs can also:

- act as a barrier to the attractiveness of employee share schemes as a form of remuneration;
- affect the likelihood of voluntary compliance by the employee; and
- potentially result in lost tax revenue.

7. When contrasted against the collection of tax under the PAYE system or the FBT rules, the current rules for collecting tax on ESS benefits is arguably inefficient for both employees and Inland Revenue.

8. The question to be addressed in this RIS is what improvements can be made to the collection of tax on ESS benefits to help simplify and improve the overall efficiency of the tax system.

OBJECTIVES

9. The main objective of this review is to simplify the way tax is collected on ESS benefits in order to improve the overall efficiency of the tax system.

10. The optimum option should:

- minimise compliance costs on employees;
- minimise administration costs for Inland Revenue;
- reduce the risk of non-compliance in connection with the taxation of ESS benefits; and
- be fiscally neutral.

11. This review is not intended to pre-empt any wider policy reforms scheduled for later stages of Inland Revenue's Business Transformation Programme. It is also not intended to alter the recognition or valuation of tax payable on an ESS benefit or change employers' entitlements to deduct the value of any ESS benefits provided to employees. These issues are part of a separate project that is on the Government's tax policy work programme.

12. We also note that the chosen option is not intended to affect the status quo treatment of employee share scheme benefits for student loans, child support, Kiwisaver, Working for Families Tax Credits and the ACC earners' levy.

² Residual income tax is the positive amount of tax still owed by an individual after subtracting the amount of any tax credits – such as tax paid by the employee through the PAYE system.

13. Trade-offs will inevitably be made across the various objectives. For example, solutions that seek to minimise Inland Revenue’s administrative costs may impose compliance costs on employers.

REGULATORY IMPACT ANALYSIS

14. Four options (including the status quo) are considered in this RIS for the collection of tax on ESS benefits. These options, which were canvassed in the April 2015 officials’ paper, are:

- Option 1 (status quo) – individuals must declare any ESS benefits in their tax return which is filed at the end of the year and any tax is collected as part of the end-of-the-year annual assessment.
- Option 2 – employers collect tax on any ESS benefits through the PAYE system.
- Option 3 – employers collect tax on any ESS benefits through the FBT system.
- Option 4 – employers collect tax on any ESS benefits through a separate withholding tax system.

15. Options, 2, 3 and 4 will tax ESS benefits at source and shift the tax obligation from employees to employers.

16. The impact of each option is summarised in the attached annex to this RIS. None of the options have:

- Social, cultural or environmental impacts.
- Fiscal impacts, although it is expected that collection of revenue should be improved by shifting the collection of tax from employees to employers.

17. In addition, we have considered whether the preferred option of collecting tax by employers should be compulsory or elective. This discussion is set out below.

Collection of tax options

Option 1 (status quo)

18. Option 1 is to retain the status quo as described under the heading “Status quo and problem definition”. We recognise that for some schemes it is more efficient for the employee to retain responsibility for meeting any tax obligations arising from the receipt of an ESS benefit and this is reflected in our comments under the heading “Conclusions and recommendations”.

Option 2: PAYE (preferred option)

19. Under this option, the employer withholds PAYE on the value of the ESS benefits and pays this amount to Inland Revenue as part of the employers' "employer monthly schedule" (EMS).

20. The main advantages of this option are:

- PAYE is a very efficient method of collecting tax and an important part of modern tax systems.
- Most payroll systems have fully automated the tax compliance obligations for PAYE and so the costs to comply with and for Inland Revenue to administer the PAYE system are relatively low.
- Despite the concerns about applying PAYE to a non-cash form of employment income (below), submitters generally preferred the PAYE option as it is generally well understood by employers and maintains the economic incidence of tax on the employee.
- The PAYE system is also better integrated with the Government's social policy programmes, subject to legislative modifications to the Accident Compensation Act 2001 and the Kiwisaver Act 2006 to ensure that amounts subject to PAYE withholding are not taken into account under these Acts.

21. The main disadvantage with this option is one of application. The underlying principle with PAYE is that tax can be readily withheld as the employees' salary and wages are in cash. However, in the case of ESS benefits (which are shares and not cash) there is an in principle difficulty with applying PAYE. To make PAYE work, employers would have to:

- recover the cost of tax from the employee, that is – deducting the tax from the employee's wage or salary;
- sell a portion of the employee's ESS entitlement on their behalf to fund the tax – assuming the ESS arrangement provided the employer with this power; or
- provide a cash gross-up to accompany the ESS benefit to fund the PAYE. Employers raised concerns that in situations where the employee and the employer had reached a bargain in terms of an employee's remuneration and ESS entitlements, an additional gross-up could make the ESS too expensive for the employer.

22. Employer concerns about funding tax payments are the same faced by employees when they have to account for tax themselves.

Option 3: FBT

23. Under this option, employers' calculate FBT on the value of any ESS benefits received by the employee and pays this tax to Inland Revenue.

24. The main advantages of this option are:

- FBT is conceptually a purer method of taxing non-cash benefits.
- FBT is designed specifically to tax non-cash benefits and remuneration received by an employee.
- FBT is designed with equity in mind by ensuring that non-cash remuneration received by employees is subject to tax at a similar level to cash remuneration. The gross-up aspect described above is built into the FBT rules via the tax rate structure and the cost of FBT and the legal incidence of the tax falls on the employer.

25. This option has a number of shortcomings, including:

- All employers have payroll systems that broadly comply with the requirements of the PAYE rules. The provision of fringe benefits, however, is less common and some employers would not have the requisite compliance systems in place to meet their obligations under the FBT rules. Using FBT as a means of collecting tax at source would therefore be unfamiliar to some employers and require them to develop new systems to manage compliance with the FBT rules. This would likely increase employer tax compliance costs over and above those incurred by employees under the status quo and could make it unattractive for employers to provide an ESS.
- From an Inland Revenue systems perspective, FBT – being a tax on the employer – is not fully integrated with the systems used to report and manage employees' child support obligations.
- For tax technical reasons, tax collected under the FBT rules means it does not count for the purposes of tax relief for employees in a cross-border context. New Zealand's Double Tax Agreement network treats FBT as an employer tax. As such, employees cannot claim any credit for New Zealand tax paid.

Option 4: Alternative withholding tax system

26. A separate method of withholding, such as using withholding regulations, was initially considered but not advanced due to constraints on Inland Revenue's ability to implement the change. As noted in the officials' issues paper *Simplifying the collection of tax on employee share schemes*, we considered there was little justification for developing a new system of withholding tax when alternative well-developed systems such as PAYE and FBT already exist.

27. Reactions from tax specialists to this option were mixed. While some considered it an optimal option, others were concerned about the prospect of having to develop new compliance systems. Others did not see the case for duplicating compliance costs under a new withholding system when the PAYE system (option 2) could be used.

Implementation: compulsory or elective

28. There are two approaches to implementing the collection of tax on ESS benefits at source. They are the compulsory approach or elective approach.

Compulsory approach

29. There are administrative efficiencies for Inland Revenue if option 2 applied to all ESS.

30. A compulsory option, however, presents a number of problems for employers and a key theme in submissions was how a source basis of collection was not appropriate for all schemes, see paragraph 48. Employers were also concerned about the impact a compulsory set of rules would have on:

- the employer's working capital – for example, if the employer is a start-up company or funding the payment of tax on the ESS benefit generally;
- agreements or understandings that exist for current schemes if it is not possible for the employer to sell shares on the employee's behalf to meet any tax liability on the ESS benefits, or otherwise affect any contractual agreements about the value of any benefits provided under the scheme;
- bargains struck between the employer and the employee and the risk to the employer having to fund the tax payable on ESS benefits;
- employee tax entitlements or obligations – for example, if the employee is a short-term tax resident of New Zealand or has tax losses or expenses he or she wishes to use against any tax liability created by the ESS benefit.

31. Submissions argued that existing schemes would need to be removed (grandparented) from the scope of any change as it would be time consuming and costly to renegotiate existing ESS agreements to provide for tax collection at source.

32. Consideration of a compulsory approach to collection of tax on ESS benefits, including grandparenting, was not advanced in recognition that in some situations it is more efficient for the employee to remain responsible for the payment of tax on ESS benefits under the status quo. This conclusion assumed, however, that any elective approach to the tax collection of ESS benefits would be supported by appropriate disclosures from the employer to Inland Revenue about their employees' (including ex-employees where any legacy entitlement exists) ESS entitlements.

Elective approach

33. An elective approach to collecting tax at source was strongly preferred by tax specialists and employers for the very reasons why compulsory rules were considered undesirable. Allowing the collection of tax to be optional permits employers to evaluate the tax benefits and costs so that the employer's obligation to collect tax using the PAYE rules applies when, in the employer's view, it is most efficient.

34. An elective approach is an effective way of reducing compliance costs. The risk with flexibility is that it reduces the efficiency of collecting tax at source. Flexibility creates additional administration costs and, by itself, does not deal with Inland Revenue's concerns in terms of ensuring employee compliance. Submissions argued that the choice should be the employer's and not the employee's. Inland Revenue agrees and further notes that any election not to withhold tax should be done on a per-scheme basis as opposed to a per-employee basis.

35. The trade-off for providing the employer with a choice is the need for Inland Revenue to have better information about when an employee receives an ESS benefit.

36. Submissions received on the officials' paper recognised that if the employer had the choice to collect tax, it was reasonable for the employer to provide information to Inland Revenue about the employees who received an ESS benefit in cases where tax was not collected at source. Submissions varied on what information should be disclosed, however. Those advocating the use of PAYE considered that employers' payroll system would meet Inland Revenue's needs. Other employers considered that the information should be separately disclosed by some other means.

37. We considered two means by which the relevant information could be received by Inland Revenue.

- ***The employer monthly schedule (EMS)***: The data points contained in the employer monthly schedule provides Inland Revenue with the information needed to administer the collection of tax on ESS benefits (irrespective of employers' election to withhold tax on the benefit). This information can be captured in a timely and administratively efficient manner without any impact on Inland Revenue's technology platforms and meet the objective that Inland Revenue can implement with minimum cost. This option will create reconciliation errors due to amounts not being counted for Kiwisaver and when the employer chooses not to withhold tax. Inland Revenue considers these errors can be tolerated as the critical information is captured and can be examined as part of any end-of-year square up process.
- ***Other alternatives – information request, letter or new Inland Revenue form***: We considered other means by which the requisite information could be captured – for example, employees' tax file numbers and the value of the ESS benefit and when it was received. This information could be captured by way of an information request, letter or a new Inland Revenue form. Inland Revenue had

concerns about whether, when contrasted against the EMS, the information would be received in a timely manner and how it would be integrated into Inland Revenue's FIRST system. Resolving these problems would increase implementation costs and raise administration risks in terms of consistent application of the proposal change, retrieval of employers' decisions about withholding, and enforcing compliance.

38. We recognise that for some employers the requirement to disclose the value of employees' ESS benefits will involve some cost. Specifically:

- the need to value shares received by employees, and
- for certain schemes ensure that the receipt of any ESS benefits is appropriately captured by employers' payroll systems. New Zealand employers whose employees participate in a global ESS may also need to ensure they receive information from their international group about any ESS benefits that vest in their New Zealand employees.

39. These costs are currently incurred by employees under the status quo.

CONSULTATION

Initial consultation

40. Preliminary consultation was undertaken by officials during the policy development phase of the project and development of an officials' issues paper. Organisations consulted included the Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, PricewaterhouseCoopers and Ernst & Young. Comments from stakeholders indicated employers and employees would generally prefer that PAYE applied to ESS benefits.

Officials' issues paper

41. In April 2015, officials released the issues paper *Simplifying the collection of tax on employee share schemes*, which is available at <http://taxpolicy.ird.govt.nz/publications/2015-ip-employee-share-schemes/overview>.

42. The issues paper discussed changing the collection of tax from ESS using the PAYE system, the FBT rules or a separate withholding tax. Both tax collection systems would shift the collection of tax on ESS benefits to a source basis. The issues paper also discussed whether any change should be mandatory or not.

43. To allow for the possibility that any reforms resulting from the issues paper could be included in a proposed taxation bill scheduled for introduction in June 2015, five weeks were allowed for consultation before submissions closed on 5 May 2015. A total of 17 submissions were received.

44. Submissions were broadly supportive of the idea of shifting the point of taxation to source, provided that the employer had the ability to elect to use the rules. Submissions also recognised that any elective use of the rules would need to be accompanied by a suitable disclosures system to allow Inland Revenue to know which employees had received an ESS benefit. Those who supported changing the collection of tax to source, agreed with the problems officials identified with the status quo. The PAYE system was the generally preferred method of collection.

45. Two submissions were strongly opposed to any change from the status quo.

46. The arguments for making any change elective, including not proceeding at all with the changes, were similar.

Main submission points

47. The main submission points centred on:

- Source basis collection is not appropriate for all schemes
- Impacts on employers
- Impacts on employees
- Interaction with the Government's social policy programmes

Source basis collection is not appropriate for all schemes

48. Submitters identified a number of instances when taxing ESS benefits at source would be inappropriate. These instances included:

- **Executive schemes:** Submissions noted that the recipients of shares under an executive scheme were generally sophisticated taxpayers who would be used to meeting their own tax obligations. Shifting the collection point to the employer would therefore not result in a reduction in compliance costs. Submissions also noted concern about situations when the tax payable, due to the size of the benefit, could exceed the taxpayer's net salary (assuming the employer is unable to sell a portion of the share entitlement on the executive's behalf to meet the tax liability on the ESS benefit).
- **International schemes:** Global employee share schemes, where the issuer of the shares is a non-resident with no other tax obligations in New Zealand, could be required to comply with the New Zealand PAYE rules for a relatively small number of New Zealand employees.
- **Schemes offered by start-up companies:** Employee share schemes are a cost effective means of remunerating staff in situations when the company does not have substantial working capital to support monetary remuneration and for

recruitment reasons need to provide a competitive remuneration package. Imposing source taxation on these schemes would make it more costly for the employer to provide and remove the advantages of including a non-cash component in a remuneration package.

49. A number of submissions noted problems with the way the Income Tax Act 2007 taxes ESS benefits with particular regard to identifying when an ESS benefit is derived and its value. Currently, the employee is responsible for these obligations as part of filing a return of income. If the collection point is moved to a source-basis, these obligations fall on the employer. The valuation of ESS benefits was identified as a particular concern for start-up companies and other non-listed companies whose shares would have to be valued and the cost of such activity would be borne by the employer.

Impact on employers

50. Submissions expressed concern at the rework required for existing payroll systems if the obligation to withhold tax was mandatory.

51. Others noted existing schemes would need to be renegotiated and any benefits would need to be re-priced. Specifically, submitters were conscious that changing the point of tax collection could interfere with existing bargains struck between employers and employees. For example, if the employer was required to withhold tax at source on ESS benefits there is a risk that the employer would have to gross-up the benefit to take into account any tax payable to Inland Revenue. Grandparenting of existing schemes, if the collection of tax at source was not optional, was suggested.

52. Others noted concerns about the ability for employers to sell shares to meet employee tax obligations. A number noted that it would not be possible to sell shares if:

- the contract under which the ESS benefit is provided did not allow for the employer to sell shares;
- the employer may in certain periods be unable to sell shares because of prohibitions under other legislation, for example, the sale of share may be illegal for reasons of insider trading during “black out” (restrictions on trading) periods or other restrictions and covenants applicable in employment contracts;
- shares in the company may not be readily sold – “illiquid shares”; this is particularly relevant for start-up companies.

53. The concern underlying these comments is the impact taxing at source would have on the employer’s working capital if the employer had to pay tax on the employee’s behalf. Submissions did not accept that the cashflow effect of collection at source would be adequately remedied by the employer selling a portion of the employee’s share entitlement to meet any tax obligations – assuming this was allowable under the relevant employee share scheme in the first place.

54. A few submissions commented on the information requirements needed to calculate the value of rights and options under an employee share scheme. Some thought the requirement

would be difficult to comply with while others noted that in their experience employers will be aware of the option exercise price as it will be specified in the share scheme offer documentation provided to the employee.

55. Other technical matters were raised in connection with how taxation at source would apply to past employees who might have legacy entitlements under an employee share scheme and the interaction of the proposals on employee entitlements under the Holidays Act 2003.³

Impact on employees

56. Submissions noted that some employees could have expenses and losses to use against any tax payable on an ESS benefit. Since these employees would be filing a return in any event, there is no point in the employer also bearing a tax compliance cost. More importantly, other employees, particularly those who are non-residents may have tax obligations in other countries. Imposing tax at source could act as a disincentive. These points argue against the use of the FBT rules.

Interaction with the Government's social policy programmes

57. Submissions generally endorsed the position that ESS benefits are counted towards an employee's child support and student loans obligations and Working for Families tax credit entitlements. Taxation at source was seen as a way of supporting the integrity of these programmes. It was noted that ESS benefits should not count for the purposes of the Accident Compensation Act 2001 and the Kiwisaver Act 2006.

58. The officials' issues paper noted the intention was not to change the status quo treatment of ESS benefits under the Government's social policy programmes.

Consultation with government agencies

59. The Treasury and the Accident Compensation Corporation were consulted and agree with our conclusions. The Ministry of Business, Innovation and Employment and Ministry for Social Development were also consulted.

CONCLUSIONS AND RECOMMENDATIONS

60. The current collection of income tax on ESS benefits presents a number of problems for employers and employees. The current rules are not necessarily well understood and the requirement that the employee must file an individual tax return to account for the ESS benefits as income and pay the tax on those benefits can lead to non-compliance. We

³ Inland Revenue notes that shifting the tax collection point to the source of the benefit does not directly impact on employee entitlements under the Holidays Act. Entitlements under the Holidays Act are based on the employee's remuneration package, not the tax treatment of such benefits.

consider that there are good efficiency and tax system integrity arguments for shifting the income tax collection point from employees to employers. We considered several options that would achieve this outcome, such as the PAYE rules (option 2), the FBT rules (option 3) or a separate system of withholding (option 4). Options 3 and 4 did not meet most of the required objectives of:

- minimising compliance costs on employees;
- minimising administration costs for Inland Revenue;
- reducing the risk of non-compliance in connection with the taxation of ESS benefits;
- be fiscally neutral;
- not affecting employees' entitlements or obligations for student loans, child support, Working for Families tax credits, Kiwisaver and the ACC earners' levy.

61. Option 2 met most of the objectives but may impose additional compliance costs on employers. Consultation with stakeholders suggested that these compliance costs meant that taxing ESS benefits at source is not always appropriate or efficient. We accept these concerns and adjusted our view about whether option 2 should have compulsory application.

62. We recommend reforming the collection of tax on ESS benefits by:

- allowing the employer to choose to withhold tax on any ESS benefits received by an employee using the PAYE system (option 2 using an elective approach).
- requiring the employer to disclose the value of any ESS benefits via the employer monthly schedule – this would apply in all cases whether the employer chose to withhold tax or not.

63. We recommend any legislative changes be included in the taxation bill scheduled for introduction in June 2015 and apply from 1 April 2017.

64. The recommended option takes into account the compliance cost concerns identified in submissions. Using the PAYE system to improve the collection of tax on employee share benefits transfers compliance costs that are currently borne by the employee to the employer. From an employee's perspective, officials consider that taxation of employee share benefits at source is a better approach to collecting tax. It is a more consistent and coherent approach to taxing employment income. It is also consistent with the general policy of simplifying employees' tax obligations. Subjecting an employee to a potentially complex filing requirement for what may be a small tax liability when that employee would not otherwise have to file a return is inconsistent with the policy objective of simplicity and reduced compliance costs.

65. For the most part, it is more efficient for the employer to bear the cost of compliance. As submissions have already argued however, where this does not hold true, the employer can elect not to withhold tax under the PAYE system.

66. The trade-off for providing the employer with a choice is the need for Inland Revenue to have better information about when an employee receives such a benefit.⁴ Employers may need to update their payroll systems to capture the requisite information.

67. The disclosure requirement may also create additional compliance costs for employers whose shares are not traded on a market exchange. As noted earlier, these costs exist currently, but they are borne by the employee. As the shares are issued by the employing company (or international group or an entity under the control of the employer), the employer is likely to have better information about the value of any share benefits.

IMPLEMENTATION

68. If approved, the preferred option will require changes to the Income Tax Act 2007, the Tax Administration Act 1994, the Kiwisaver Act 2006 and the Accident Compensation Act 2001.

69. These changes can be included in the next taxation bill scheduled for introduction in June 2015.

70. The legislative changes would apply from 1 April 2017 to allow employers and software developers' sufficient time to implement the necessary payroll and information systems changes to allow withholding and comply with the disclosure of ESS benefit information to Inland Revenue.

71. When introduced into Parliament, a commentary on the bill will be released explaining the amendments and further explanation of their effect will be contained in a Tax Information Bulletin, which would be released shortly after the bill receives Royal assent.

72. Inland Revenue will administer the proposed changes. Enforcement of the changes would be managed by Inland Revenue as business as usual.

73. The proposed changes largely align with Inland Revenue's existing systems. It is expected that using the EMS to receive information about ESS benefits may generate return errors if the employer does not withhold tax. These errors would require Inland Revenue to undertake additional manual work to correct. However, this is seen as a reasonable trade-off for the improved information Inland Revenue would receive about employees' ESS benefits. Inland Revenue is preparing suitable communications materials for employers about the changes.

74. Submissions recognised the importance of counting the value of ESS benefits for determining employee social policy entitlements and obligations and that any changes to the collection of tax should not change the status quo. As noted in the officials' paper, it is not

⁴ It is possible that the disclosure requirement would also apply to ex-employees in the rare case when legacy entitlements might exist under an employee share scheme agreement. This may require, if the employer does not already do so under the scheme, additional communications between the employer and ex-employee regarding any entitlements.

the intention to change the way ESS benefits are treated for the purposes of child support, student loans, Working for Families tax credits, ACC and Kiwisaver. ESS benefits should not count for the purposes of the ACC earners' levy and Kiwisaver contributions and changes are required to the Accident Compensation Act 2001, and the Kiwisaver Act 2006 to ensure this outcome.

75. ESS benefits would continue to count toward child support, student loans and Working for Families tax credits.

MONITORING, EVALUATION AND REVIEW

76. In general, Inland Revenue monitoring, evaluation and review of collecting tax on ESS benefits would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

77. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary would be added to the tax policy work programme, and proposals would go through the GTPP.

SUMMARY OF IMPACTS OF THE OPTIONS (INCLUDING THE STATUS QUO)

Option 1: Status quo

Description	Impacts			
	<i>Employees</i>	<i>Employers/payroll intermediaries and software developers</i>	<i>Tax system (by reference to the integrity of the tax system, impact on Inland Revenue and revenue impact)</i>	<i>Society (by reference to social policy programmes administered by Inland Revenue)</i>
No tax withheld at source.				
Advantages	-	-	-	-
Disadvantages	<p>Compliance costs associated with filing returns and payment of tax on any ESS benefits received.</p> <p>If the amount of tax payable exceeds \$2,500, the employee faces the prospect of having to comply with the provisional tax rules and accounting for tax in instalments throughout the year.</p> <p>Employees need to have cash resources to meet any tax obligations.</p>	-	<p>Risk to the tax base from employee non-compliance.</p> <p>Inland Revenue incurs higher administration costs associated with processing returns and any necessary enforcement action.</p> <p>Elevated tax collection risk due to employees being uncertain about their obligations under the Income Tax Act 2007.</p>	-
Mitigating factors	Employees can sell shares to meet any tax liabilities.	-	-	ESS benefits counted towards any obligations/entitlements for child support, student loans or Working for Families tax credits.
Conclusion:	Employee bears the cost of compliance and associated tax risk. Inland Revenue faces increased non-compliance risk.			

Option 2: Collection using the PAYE system (preferred option)

Description	Impacts			
Tax on ESS benefits is collected using the Pay As You Earn (PAYE) system	<i>Employees</i>	<i>Employers/payroll intermediaries and software developers</i>	<i>Tax system (by reference to the integrity of the tax system, impact on Inland Revenue and revenue impact)</i>	<i>Society (by reference to social policy programmes administered by Inland Revenue)</i>
Advantages	Employees have more certainty about the tax treatment of ESS benefits including their obligations. Reduced compliance costs.	Increased employee certainty about the tax treatment of ESS benefits may support the take up of such schemes and inclusion in remuneration packages. All employers have PAYE systems.	Improved compliance. Improved tax collection. Reduced revenue risk. Reduced administration costs for Inland Revenue from fewer individual tax returns and follow up enforcement action.	ESS benefits counted towards any obligations/entitlements for child support, student loans or Working for Families tax credits.
Disadvantages	Possible risk that tax payable on ESS benefits could exceed income.	Employers need to change payroll systems to include ESS benefits. If compulsory, it may: <ul style="list-style-type: none"> • affect the employer's working capital by having to fund the necessary tax payments; • alter agreements or understandings between the employee and employer; • unnecessarily interfere with the employee's tax entitlements or obligations. 	-	Possibility that reconciliation errors are created due to amounts not being counted for Kiwisaver and when the employer chooses not to withhold tax. This will require additional rework of the EMS by Inland Revenue.
Mitigating factors	Employee and employer can agree to sell part of employees' ESS entitlement to meet any tax obligations.	Grandparenting existing schemes could be considered to mitigate the effects on employers.	-	Additional legislative change to ensure ESS benefits do not count for the purposes of the ACC earners' levy and Kiwisaver.
Conclusion:	Transaction costs associated with collecting tax on ESS shifted from the employee and Inland Revenue to the employer. Issue over whether tax payable on ESS benefits can be solved, for the most part, by the employer selling shares to meet tax obligations.			

Option 3 Collection using the FBT system

Description	Impacts			
Tax on ESS benefits is collected using the Fringe Benefit Tax rules	<i>Employees</i>	<i>Employers/Payroll intermediaries and software developers</i>	<i>Tax system (by reference to the integrity of the tax system, impact on Inland Revenue and revenue impact)</i>	<i>Society (by reference to social policy programmes administered by Inland Revenue)</i>
Advantages	Employees have more certainty about the tax treatment of ESS benefits including their obligations. Reduced compliance costs.	Increased employee certainty about the tax treatment of ESS benefits may support the take up of such schemes and inclusion in remuneration packages. The gross up of tax on the fringe benefit means that any resulting tax obligation will not exceed the employee's income.	Improved compliance. Improved tax collection. Reduced revenue risk. Reduced administration costs for Inland Revenue from fewer individual tax returns and follow up enforcement action.	ESS benefits counted towards any obligations/entitlements for student loans and Working for Families tax credits.
Disadvantages	Problems with getting appropriate tax relief if the employee is a non-resident under New Zealand's Double Taxation Agreement network.	May create additional compliance costs on employers. Need to change FBT reporting systems to include ESS benefits. FBT obligations may apply to employers who have limited experience with FBT. Out of step with international practice. For global employee share schemes, the FBT rules would affect employees' ability to receive tax relief under New Zealand's DTA network.	Out of step with international practice.	Systems constraints means that ESS benefits are not counted for child support purposes.
Mitigating factors	-	Inland Revenue education programmes to improve employer understanding about their FBT obligations including online calculators.	-	-
Conclusion:	Conceptually purer method for taxing non-cash benefits, but has implementation problems and could apply to employers who are not familiar with the tax obligations arising from providing non-cash benefits.			

Option 4: Collection using a withholding tax

Not considered in depth due to concerns that Inland Revenue would not be able to implement the method. Alternative well-developed systems such as PAYE and FBT already exist.

Recommended proposal: Employer election with data capture using the PAYE's employer monthly schedule (EMS)

Description	Impacts			
<p>Employer to choose to withhold tax on any ESS benefits received by an employee using the PAYE system</p> <p>Employers disclose the value of any ESS benefits via the employer monthly schedule – this would apply in all cases whether the employer chose to withhold tax or not.</p>	<p><i>Employees</i></p>	<p><i>Employers/payroll intermediaries and software developers</i></p>	<p><i>Tax system (by reference to the integrity of the tax system, impact on Inland Revenue and revenue impact)</i></p>	<p><i>Society (by reference to social policy programmes administered by Inland Revenue)</i></p>
<p>Advantages</p>	<p>Employees may have increased certainty about the tax treatment of ESS benefits including their obligations.</p> <p>Reduced compliance costs.</p>	<p>Increased employee certainty about the tax treatment of ESS benefits may support the take up of such schemes and inclusion in remuneration packages.</p> <p>Reduced impact on employers if the obligation to pay tax stresses employers' working capital or interferes with bargains struck between the employer and employee.</p> <p>Cost of compliance is shifted from the employee to the employer when the employer considers there is an overall net benefit to do so.</p>	<p>Improved compliance.</p> <p>Improved tax collection.</p> <p>Reduced revenue risk.</p> <p>Reduced administration costs for Inland Revenue from fewer individual tax returns and follow up enforcement action.</p>	<p>ESS benefits counted towards any obligations/entitlements for student loans and Working for Families tax credits.</p> <p>ESS benefits counted for child support purposes.</p>
<p>Disadvantages</p>	<p>Advantages described above are not fully captured if employers decide</p>	<p>May create additional compliance costs on employers.</p>	<p>Advantages described above are not fully captured if employers decide</p>	<p>Possibility that reconciliation errors are created due to amounts not</p>

	<p>not to withhold tax on ESS benefits received by employees.</p> <p>Risk of unintended non-compliance if the employer chooses not to withhold and the employee is unaware of their tax obligations.</p>	<p>Need for legacy record keeping to ensure that elections are properly captured.</p> <p>Employer responsible for declaring any ESS benefits entitlements accruing to ex-employees.</p>	<p>not to withhold tax on ESS benefits received by employees.</p> <p>Risk of unintended consequences if the employer chooses not to withhold and the employee is unaware of their obligations under the Income Tax Act 2007.</p> <p>Election is more expensive for Inland Revenue to administer.</p>	<p>being counted for Kiwisaver and when the employer chooses not to withhold tax. This will require additional rework of the EMS by Inland Revenue.</p>
Mitigating factors	<p>Employee share agreement should clearly articulate the employee's tax obligations.</p> <p>Inland Revenue to develop a suitable communications strategy to inform employers about their obligations.</p>	<p>Employer can elect not to withhold tax.</p>	<p>Inland Revenue captures income information about ESS using the EMS.</p>	<p>Additional legislative change to ensure ESS benefits do not count for the purposes of the ACC earners' levy and Kiwisaver.</p>
Conclusion:	<p>Takes into account employers' compliance cost concerns about shifting the obligation to collect tax at source and improves the integrity of the tax system by using the PAYE system to improve the collection of information about employee entitlements under an ESS.</p>			