

# Taxation of employee share schemes: start-up companies

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*An officials' issues paper on a deferral regime for start-up companies*

May 2017

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# CHAPTER 1

## Background

- 1.1 This consultation document expands on a proposal raised in an officials' issues paper released for public feedback in May 2016.<sup>1</sup> It examines in closer detail a proposal for the taxation of employee share schemes (ESS) offered by start-up companies. The proposal would provide the ability to defer the taxation point for employees of start-up companies (with a corresponding deferral of the company's deduction).
- 1.2 ESS are an important way of incentivising and remunerating employees in New Zealand and internationally. It is important that their treatment under New Zealand tax law does not advantage or disadvantage their use compared to other forms of remuneration. The thrust of the proposals in the May 2016 issues paper was to ensure that the taxation of ESS benefits is consistent with the taxation of cash remuneration. Officials released a further consultation document in September 2016<sup>2</sup> seeking submissions on the updated proposal. The policy recommendations resulting from this second round of consultation are contained in the recently introduced Taxation (Annual Rates for 2017–18, Investment and Employment Income, and Remedial Matters) Bill.
- 1.3 Chapter 6 of that issues paper discussed and sought submissions on the possibility of a deferral regime for start-up companies. This deferral regime would delay the point that the employee was required to pay tax on the benefit from ESS (with a corresponding deferral of the company's deduction). The proposal was also discussed with stakeholders who were open to the possibility of an elective regime for start-up companies.
- 1.4 The purpose of this paper is to provide more detail on a possible deferral regime, and determine through consultation whether a fair deferral regime can be developed.
- 1.5 The approach taken in this paper is not intended to provide a tax concession. The "cost" of deferring the taxing point is that employees will, in effect, be taxable on any gains on the shares until the deferral taxing point occurs. Of course, where the shares decline in value, this will result in less tax for the employee.

### **Taxation of employee share scheme income as proposed in the Bill**

- 1.6 The proposals in the Bill<sup>3</sup> were designed to ensure that employees will be taxable on shares received in connection with an ESS once the shares are earned by the employee, and they become the "economic owner" of the shares. Broadly speaking, an employee is the "economic owner" of the shares when all conditions and contingencies relating to their ownership or

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<sup>1</sup> *Taxation of employee share schemes: An officials' issues paper*, Inland Revenue (May 2016).

<sup>2</sup> *Tax treatment of employee share schemes – further consultation*, Inland Revenue (September 2016).

<sup>3</sup> *Taxation (Annual Rates for 2017–18, Investment and Employment Income, and Remedial Matters) Bill*.

retention of the shares have fallen away, so that they hold them on substantially the same basis as non-employee shareholders. This is defined in the Bill as the “share scheme taxing date”. The amount of income is the value of the shares at the share scheme taxing date, less any amount the employee pays for the shares.

1.7 Conditions and contingencies can include:

- The possibility of loss of the shares if the person does not remain employed for a future period, or if the company’s performance does not meet certain benchmarks.
- Where the employer sells shares to the employee and provides a limited-recourse loan to finance the purchase price.

## **Proposals**

### ***Tax deferral schemes for start-up companies***

1.8 This issues paper considers the feedback received on the May 2016 issues paper in relation to start-ups. It then uses those as a starting point for discussing revised proposals.

1.9 For unconditional share schemes, that is, where ordinary shares are provided to an employee with no conditions attached to them, the tax treatment will not change under the proposals in the Bill. These shares will give rise to employment income when the shares are acquired. In the case of employee share options, employees are generally taxed when the options are exercised.

1.10 The proposals in the Bill generally would have the effect of taxing ESS benefits at the same time or later than they are currently taxed. Nevertheless, some submitters commented that taxing share benefits is problematic where the employee cannot sell the shares at the taxing point. This is for two reasons. First, it might be difficult to find the cash to pay the tax. Second, valuation might be problematic. Both of these issues are likely to be at their most pressing for early stage or start-up companies. That is the basis for the deferral proposal for start-up companies in this issues paper, which is discussed in Chapters 2 to 8.

1.11 This paper seeks further submissions on details regarding the design of a deferral scheme. This includes a discussion on:

- the scope of the deferral measure;
- the nature and timing of the election;
- when the tax impost should arise under the deferral scheme;
- timing of deductions for the employer; and
- matters of administration and compliance.

### *Ensuring the R&D loss cash-out can apply to ESS benefits*

- 1.12 In Chapter 9 we discuss the interaction of the ESS start-up proposals and the existing R&D loss cash-out regime and propose to ensure that ESS costs to the employer are appropriately dealt with under that regime.
- 1.13 Feedback on this issues paper will be used to help shape recommendations to Government for its consideration and inclusion in a future tax bill.

### **How to make a submission**

- 1.14 Officials invite submissions on the suggested changes and points raised in this issues paper. Send submissions to [policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz) with “Taxation of employee share schemes: start-up companies” in the subject line.
- 1.15 Alternatively, submissions can be addressed to:  
  
Taxation of employee share schemes: start-up companies  
C/- Deputy Commissioner, Policy and Strategy  
Inland Revenue Department  
PO Box 2198  
Wellington 6140
- 1.16 The closing date for submissions is **12 July 2017**.
- 1.17 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.
- 1.18 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.





## CHAPTER 2

### Valuation and liquidity issues for start-up companies

- 2.1 During the course of further consultation on the detail of the proposals contained in the May 2016 issues paper, submitters raised concerns that the general proposals did not address the valuation and liquidity issues faced by start-up companies offering ESS benefits.
- 2.2 In particular, if the tax from receiving an ESS benefit arises without a sale or an active market for the shares, and where there may be little or no earnings history or realisable assets, it is difficult to determine the shares' value so as to work out the tax liability. Even if the shares can be valued, the employees are often unable to sell a portion of their shares to meet the tax liability and therefore have to fund the liability from other income or borrowings – thus making the scheme less attractive. The employer could provide cash income to pay the tax. However, start-up companies typically experience cashflow constraints as well and therefore the problem is simply transferred to the employer.

#### Valuation

- 2.3 Under both the current law and the proposals in the Bill, calculating the tax payable by an employee often requires a valuation of the shares at the relevant taxing point.
- 2.4 If the shares are in a listed company, the value of the shares at the time tax is payable can be easily found. It is more difficult to determine the value of the shares in an unlisted company, particularly if it is an early stage or start-up company, with little or no operating history, no cashflows and very few tangible assets. For example, the value of such a company may depend completely on its success in developing an untested idea, and as such is extremely speculative. In such a case, determining the value of the shares is an uncertain and difficult exercise, as well as a potentially expensive one.
- 2.5 Inland Revenue has recently introduced valuation guidelines for shares received by an employee under an ESS.<sup>4</sup>

#### Liquidity

- 2.6 Start-up companies are also often cash constrained – all available cash is allocated to developing the business. This is one reason they use employee share schemes to remunerate employees – because it reduces the amount of cash salary they have to pay. Similarly, an employee who accepts part of their remuneration in shares may not have a lot of extra cash. They may

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<sup>4</sup> Commissioner's Statement CS 17/01 – *Determining "value" of shares received by an employee under a share purchase agreement.*

receive a modest cash salary to cover living costs and the rest of their remuneration in shares.

- 2.7 Compounding this issue is that in early-stage companies, and often in a broader set of unlisted companies, there is a very limited market for the employee's shares. The employee will also often be prohibited from selling the shares other than to existing shareholders (and in some cases, that also may be impermissible) by the terms of the scheme. However, there will usually be no requirement for the existing shareholders to buy the shares. This makes it very difficult for the employee to sell their shares.
- 2.8 Because the shares may not be easily sold to generate cash, submitters have raised the imposition of tax on the ESS benefit received as a barrier to using ESS. Under current law, subject to the potential application of the general anti-avoidance rule, it has been possible to provide share benefits to employees without any income tax arising. So in many cases, this practical cashflow issue may not have been relevant because there is simply no tax to pay. The proposed measures in the Bill prevent the use of these structures to avoid tax. While this is the correct economic outcome, officials recognise the case for considering ways to reduce the difficulty of meeting a tax cost from receipt of illiquid shares.

#### **Self-help solution – long-term options**

- 2.9 Under current law, it is possible to legitimately structure an employee share scheme so that it has the practical effect of deferring the taxing point – thus avoiding or minimising issues of liquidity and valuation. This can be done by using what is known as a long-dated option.
- 2.10 For example, if an employee is given an option which expires in 20 years, the employee can defer the taxing point in relation to that option until the company has an initial public offering (IPO) or the employee wishes to sell the shares. The employee can wait until that time to exercise the option. The employee will then have income equal to the value of the shares at that time, less the option price. This avenue for avoiding cashflow and liquidity issues is not affected by the Bill.
- 2.11 However, submitters have said that option holders may not have the same sense of ownership as shareholders. Option holders do not ordinarily have certain rights held by shareholders in a company, including the right to vote. Share ownership is desirable as it aligns the employees' motivations with the company's.
- 2.12 Submitters also explained that long-dated options are undesirable from the perspective of other shareholders and may result in a significant accounting expense for employers that have to comply with IFRS.
- 2.13 Therefore submitters said that, as a practical matter, many companies may not wish to take advantage of this self-help solution.

## CHAPTER 3

### Deferral regime for start-up companies

- 3.1 In the May 2016 issues paper, we asked for submissions on the desirability of a regime which would allow employees in start-up companies to elect to defer the recognition of ESS income until there was a “liquidity event” to fund the tax on the income (for example, when the shares are sold or listed or the assets of the company are sold and the proceeds are distributed when the company is wound up). The employee would be taxed on the value of the shares at this time, less any amount the employee paid for them (and the employer would be entitled to a corresponding deduction at that time).
- 3.2 This would address both the valuation and liquidity issues. For example, at the time the shares are listed, there is an established market value and the employee can sell some shares to get the cash with which to satisfy the tax liability.
- 3.3 Deferral of taxation yields an after-tax outcome for the employee which is equivalent to upfront taxation. The taxation of the changing value of the share can be shown to be equivalent to upfront taxation, without the attendant problems of valuation and cashflow. The intuition is that scaling down the amount invested at the outset of the arrangement through taxation is equivalent to scaling down the benefits by the same percentage through taxation at a later time (that is, when there is a sale or listing of the shares).

#### **Example 1: Simple comparison of tax at issue and deferred tax**

An employee receives \$100 of wages, pays tax (or not if tax is deferred), and invests the after-tax proceeds in shares of the company. Suppose the share value increases by a factor of ten between the investment date and the date when the employee sells them.

##### **Tax at issue**

Tax of \$33 is paid upfront, leaving an after-tax amount of \$67 to be invested in shares of the company.

The shares go up 10 times to \$670.

##### **Deferred tax**

No tax is paid upfront and \$100 is invested in the shares of the company.

The shares go up 10 times to \$1,000, and tax of \$330 is paid when the shares are sold, leaving the same net position of \$670.

##### **Conclusions**

Tax at issue and deferred tax at sale are equivalent.

Reducing the amount invested by 33% upfront is equivalent to reducing the proceeds by 33% at the end.

The small amount of tax of \$33 upfront leaves the employee in the same net position as the large amount of tax of \$330 at the end.

- 3.4 Under a deferral regime, from the moment that a liquidity event has occurred and the employee's taxable income is calculated, the employee would hold the shares on the same basis as any other shareholder – that is, based on their specific circumstances they may hold the shares on capital account. For example, if an employee continues to hold the shares after an IPO, and did not acquire the shares for the purpose of disposal, then only the increase in value arising between the time the shares or options were granted and when the shares are listed would be taxed. If the shares continued to increase in value after the IPO, those gains would in most cases be tax-free capital gains.

**Example 2: Deferral of tax on exercising options**

An employee has options to acquire 10,000 shares in the company for \$1 per share. The option can be exercised once the employee has been working for three years, and the option does not expire for a further two years.

The employee exercises their options for \$10,000 five years after they are granted. As there is no secondary market for the shares it is difficult to establish their market value. An election has been made to defer the tax on shares issued under the ESS.

At the end of year six the company is listed with a share price of \$5 per share. This ends the deferral period and the employee is taxed on income of \$40,000 (\$50,000 of shares less the \$10,000 purchase price).

The employee sells 500 shares a year later for \$7 per share. In most cases there will be no tax to pay, as the shares are held as a capital asset.

**Forfeiture of tax losses for employers**

- 3.5 Start-up companies generally generate unusable tax losses in their early years of operation, only to forfeit these losses when third party investors buy a stake in the company (because they lose shareholder continuity at that point). It is also after this point in time when companies are likely to be generating a net profit and would like to be able to use the earlier carried forward losses to reduce their current year tax bill.
- 3.6 Therefore, allowing employers a tax deduction for ESS benefits at an early stage in the company's life cycle may not be particularly beneficial for start-up companies who often expect to forfeit their tax losses at some stage.
- 3.7 The ability to defer the taxing point for ESS benefits and the associated tax deduction to a time when they are more likely to be able to use the deduction is likely to be attractive for start-up companies. On the basis that tax deferral applies to deductions as well as income, a deferral scheme may be useful to employers directly.

## **Other possibilities**

- 3.8 There are at least two other possible approaches that could be taken to deal with the issues faced by start-up companies.

### ***Non-deductible and non-assessable approach***

- 3.9 One approach would be to exempt the income and deny a deduction. This is the approach taken for widely offered share schemes. It is concessional compared with the tax treatment of other forms of remuneration in two respects. First, insofar as the employee's marginal rate is higher than the corporate rate and second, where the employer is in tax loss. As to the first of these, while at 5% the current margin is not particularly high, it is possible that may change in the future. Accordingly, we do not propose to extend this treatment beyond the ambit of the widely offered schemes. As to the second, because the ESS benefits may be relatively significant, it does not seem appropriate to treat them as non-assessable to the employee, even if deductions were denied to the employer. Officials believe the deferral proposal is a preferable solution to the issues faced by loss companies.

### ***Cashing out losses***

- 3.10 A second approach would be to cash out the ESS deduction in the case of a loss making company. This would eliminate the rate differential issue, assuming the cash out is at a 28% rate. It would provide the company with most of the money required to pay PAYE or a cash gross-up paid to the employee. Again, however, it would be a significant departure from our current taxation of employment remuneration. Currently, losses are able to be cashed out only where the R&D loss tax credit regime applies. We propose to ensure this applies to ESS benefits like other forms of remuneration. It does not seem appropriate from a policy perspective to allow a cash out to apply to a certain form of remuneration and not to other expenses.

#### **Submission points**

- Do submitters think a deferral regime would be attractive to employers?
- Is there any alternative arrangement that would be attractive to companies and would not result in under-taxation?



## CHAPTER 4

### Scope of deferral measure

- 4.1 In the May 2016 issues paper, we asked submitters for their views on which companies should be eligible to offer schemes with a deferred taxing point. For practical and administrative reasons, our proposal is to restrict the availability of the deferral regime to “start-up” companies (as defined).

#### Defining “start-up” companies

- 4.2 Some submitters suggested that in principle, the deferral option should be available to all companies without share liquidity. This could include all companies that are not quoted on the official list of a recognised stock exchange.
- 4.3 However, opening up the availability of deferral too widely could cause administrative difficulties for Inland Revenue, especially in the area of auditing compliance with the deferral regime, for example. Some restrictions on the availability of deferral are therefore necessary.
- 4.4 Further, more mature unlisted companies:
- can generally put in place mechanisms to deal with liquidity problems, because they are likely to have more cash than true start-ups;
  - are more likely to have an earnings history or tangible assets which can be used to value the company.
- 4.5 Start-ups are especially affected by the valuation and liquidity problems because they lack the cash to pay the tax on behalf of their employees, and their shares are more difficult to value using orthodox methodologies.
- 4.6 There are difficulties associated with defining a “start-up company”. In Australia’s recently enacted start-up concession for ESS, a “start-up company” is, broadly speaking:<sup>5</sup>
- an unlisted Australian company;
  - less than 10 years old; and
  - with annual turnover less than A\$50 million.

All three tests apply on a group basis.

- 4.7 One issue with this approach is that it creates a “cliff face” – once a company earns \$1 more than \$50 million or is 10 years and one day old, it is ineligible for the regime. This could, in theory at least, create perverse incentives at the

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<sup>5</sup> Section 83A-33, Income Tax Assessment Act 1997 (Australia).

margins – for example, a company would not want to earn more revenue because it would lose eligibility to adopt the deferral approach. For New Zealand’s purposes, we would prefer a definition which clearly excludes companies that would not have the same liquidity and valuation problems that start-ups do.

- 4.8 However, we consider that similar restrictions should be put in place in New Zealand so that unlisted companies that have enough cash and sophistication to overcome the valuation and liquidity problems are not included in the definition of “start-up”. The “cliff face” issue does necessitate a more careful analysis of what the parameters should be, and we welcome submissions on this point. Officials propose an annual turnover limit of \$10 million per annum, reflecting the level of income at which a New Zealand company could be said to have left the start-up category.
- 4.9 Companies in certain industries may be able to satisfy the above criteria despite not being subject to the same valuation constraints faced by, for example, a start-up company in the technology industry which is developing some new, untested product to take to market. One option is for there to be a low value of tangible assets owned by a company in order to qualify for the deferral regime. Instead, or as well as an asset threshold, legislation could list a number of activities which would disqualify a company from the deferral regime. For example, section CW 12 sets out, for another purpose, a list of industries that may be considered for this purpose. These are land development, insurance, land ownership, mining, construction or acquisition of public infrastructure assets.<sup>6</sup>
- 4.10 In addition, officials seek comments on whether it would be appropriate to define a start-up company as one that has not paid a dividend. Payment of a dividend is an indicator of available cash (so liquidity is much less of an issue) and may also indicate that the company is easier to reliably value.
- 4.11 Ceasing to qualify as a start-up would have no effect on shares or share benefits already identified as subject to the deferral regime. It would simply prevent the company from issuing further shares subject to the regime.

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<sup>6</sup> Section CW 12 exempts proceeds from share disposals by qualifying foreign equity investors, unless the resident company is engaged in certain activities. Australia also has rules prohibiting share trading and investment companies from accessing the deferral regime.



### **Submission points**

We are interested to hear from readers:

- Do submitters agree with the thresholds for defining a start-up company being based on the three categories used in the Australian rules (that is, size, age and whether it is listed)?
- If a threshold for the relative or absolute value of tangible assets was introduced, what would be an appropriate threshold?
- If certain industries were to be excluded from this proposal, which industries would these be?
- What other thresholds or indicators might be appropriate?



## CHAPTER 5

### Deferral measure – elections

- 5.1 We are seeking submissions on whether the proposed taxing point deferral should be elective or mandatory.
- 5.2 If the deferral is elective, then the following decisions will need to be made:
- who should make the election;
  - when should the election be made; and
  - whether the election should be on a scheme-by-scheme or grant-by-grant basis.

#### Compulsory versus elective

- 5.3 The deferral proposal described in this issues paper is designed to assist start-ups with liquidity and valuation issues. If companies would prefer to deal with these issues in other ways, this should be open to them. Therefore we do not believe that it should be compulsory for companies meeting the start-up definition to have to use the deferral regime.
- 5.4 Accordingly, some form of election should be possible.

#### Election by company versus employee

- 5.5 As an underlying principle, because both the employer's and employees' tax positions are affected by deferral, they should both have certainty as to their tax position and, if an election to defer tax is being made, they should both be aware of it before committing to the share scheme.
- 5.6 Schemes will be implemented in most cases by the company. The company will have the responsibility for providing information about scheme benefits, and paying PAYE if elected, at the taxing point to Inland Revenue. The company will also have to put the amount of the share scheme benefit into its return as a deduction.
- 5.7 Accordingly, it seems sensible for the deferral election to be made by the company, in advance of the benefit being agreed to be provided. In this way, the employee will know in advance (that is, before agreeing to take remuneration in shares) the basis on which they will be taxed, and can make decisions accordingly.
- 5.8 It would seem simpler for the election to be made on a scheme-by-scheme basis. However, there would be nothing to prevent an employer providing both a deferred and non-deferred scheme, and allowing the employee a choice of scheme, if it wished to do so. An existing scheme could elect to

defer, or not, and a scheme that was previously deferring that subsequently breached an eligibility threshold could continue on a non-deferred basis for subsequent issues.

- 5.9 This approach provides greater certainty to both the employer and employee in relation to their relevant tax positions under the scheme.
- 5.10 Another option would be for the employer to be able to choose to defer on an employee-by-employee basis. This would allow them to consult with the employee before deciding whether to provide their shares on a tax-deferred basis. This provides greater flexibility than the scheme-by-scheme approach.

### **Timing of election**

- 5.11 To provide certainty and reduce opportunities for avoidance, it seems desirable for elections to be made up-front – or potentially even be part of the terms of the schemes.
- 5.12 In Australia, at one time and for certain schemes, employees were able to elect whether to be taxed on an upfront or deferred basis. However, the law was amended so that from 1 July 2009, shares offered under a qualifying deferred taxation scheme were automatically subject to the deferred taxing point. In other words, whether a share or right is subject to taxation up-front or at a later time depends on the structure of the scheme. Employees cannot elect to pay tax upfront on shares received under a qualifying deferred taxation scheme, but employees and employers are free to elect whether or not to participate in or offer a qualifying deferred taxation scheme – which is effectively an election to be taxed upfront or not, made at the time that the scheme is set up. This change was made to reduce the scope for tax avoidance, and also to make it easier for employers to comply with their reporting requirements.
- 5.13 Officials' preference is for the election to be made on a scheme-by-scheme basis, at the time a scheme is set up, or when the deferral rules applied for existing schemes.

### **Submission points**

We are interested to hear from readers:

- Whether any deferral regime for start-up companies should be elective or mandatory.
- If elective, on what basis (scheme-by-scheme, employee-by-employee)?
- Should the choice to defer payment of the tax be available to the employer or the employee?
- What other design issues need to be considered for a deferral scheme?

## CHAPTER 6

### Deferred taxing point

- 6.1 The issues the deferral proposal is trying to address are the lack of liquidity and difficulty of valuing shares.
- 6.2 Once employees have sold their shares, obviously both of these issues have been resolved, so tax should be payable no later than that time.
- 6.3 However, there are other events that should also potentially trigger the taxing point for shares – either because the liquidity and valuation issues have been resolved, or there are important integrity reasons for tax to be triggered.
- 6.4 Therefore in addition to the sale of the shares, we believe the following events should also trigger the taxing point:
- an initial public offering (IPO) of the shares on a recognised exchange;
  - sale of the company’s assets followed by distribution to shareholders when the company is wound up;
  - cancellation of the shares, including on the company being struck off (this will be a relatively common occurrence for start-up companies);
  - ceasing to be a New Zealand tax resident;
  - a “sunset” date – for example, recognition of income cannot be delayed by more than 7 years.
- 6.5 The occurrence of any one of these events will give rise to a tax liability to the employee and a deduction to the employer if the shares are worth more than their cost to the employee, and an obligation on the employer to report the amount of the benefit on the employer monthly schedule (EMS). This assumes that the usual share scheme taxing date has already passed. For example, if the employee holds a share option, at the time one of these events occurs, the event will not trigger income or a deduction.

#### Initial public offering

- 6.6 An IPO will establish an objective market value for the shares and will also provide an opportunity to sell some shares to pay the tax. Share values often fluctuate significantly in the period shortly after an IPO, therefore if the employee actually sells their shares within a set period of time after the IPO, we suggest that it is the sale price – not the listing price, or some other weighted average value – that is used to determine the employee’s tax liability in relation to the shares sold.
- 6.7 We are interested in submissions on what may be an appropriate period to allow the shares to be valued on their sale price rather than the IPO listing

price. In Australia if shares are sold on-market within 30 days of the deferred taxing point the sale proceeds from the shares can be taken as their market value.

- 6.8 Employers will need to take steps to ensure they are aware of these values. As the deduction will arise immediately after the IPO, the employer's deduction will not be affected by any IPO-related ownership changes which otherwise might see the employer forfeit previously carried forward tax losses from unused ESS deductions. This is another advantage of deferring the taxing point.

### **Distribution of assets**

- 6.9 Start-ups can reach a liquidity point by selling the company's assets to a third party. The start-up would then distribute these assets (often cash or shares in the acquiring company) to its shareholders when the company was wound up. Due to earn-out periods<sup>7</sup> it can be difficult to ascertain the value of the shares even at the point the assets are sold. It would not be appropriate to value the shares provided under an ESS when the shares were cancelled as at this point they will have zero value. One option would be to tax shareholders with deferred ESS benefits on the value of distributions to the extent it exceeds what they paid for the shares. We invite submissions on this issue.

### **Cancellation of shares**

- 6.10 At the point shares are cancelled the employee no longer holds an interest so there is no benefit in deferring the taxing point beyond this.

### **Ceasing to be a New Zealand tax resident**

- 6.11 When an employee ceases employment with a group they may be entitled to retain shares or options that have yet to reach a taxing point. This creates an administrative risk whether these now former employees will comply with their obligations.
- 6.12 The Australian start-up rules use leaving employment as a trigger for the taxing point. In Australia, an employee is considered to have ceased their employment with the company if they are no longer employed by any company in the same group. Cessation of employment would likely occur once a person receives the last payment they are entitled to which is subject to PAYE.
- 6.13 Implementing an equivalent rule in New Zealand would provide a tax incentive for an employee to stay with the same company when in the absence of tax they would not.

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<sup>7</sup> An earn-out period is where a portion of the sale price is dependent on the future performance of the acquired business. These are used to keep pre-acquisition employees involved or where there is uncertainty over future growth prospects.

- 6.14 If employees did not trigger the taxing point upon leaving employment, former employees would continue be required to return tax on the ESS benefit even though they were no longer employed by the company.
- 6.15 Enforcing these obligations, however, will be much easier if the former employee continues to be a New Zealand tax resident. Therefore, we propose the deferral period should only continue while the former employee remains New Zealand tax resident.
- 6.16 The rules should not encourage New Zealand employees to leave New Zealand to escape their tax obligations and requiring tax to be paid at the time the individual left New Zealand would achieve this. This is also consistent with many other sections of the Income Tax Act 2007 where a liability is crystallised at the point the person ceases to be a New Zealand tax resident.

### **Sunset period**

- 6.17 We believe it is desirable to provide a finite date at which deferral lapses. This is to prevent the start-up rules allowing an indefinite deferral of tax liability. For instance, we understand that in some jurisdictions bespoke financing packages are available to allow employees in successful start-ups to monetise the value of their share scheme benefits without triggering a taxing point – thus avoiding tax permanently on the employee share scheme benefits. To prevent this we propose a “sunset” period. When this period expires, the taxing point will be triggered regardless of whether one of the other events has occurred.
- 6.18 The Australian rules include a “sunset” period of 15 years (recently extended from 7 years). After 15 years, tax becomes payable even in the absence of another liquidity event occurring, because it is considered that after that amount of time there is (or is very likely to be) either liquidity or no prospect of liquidity.
- 6.19 In our view, a company is likely to have a liquidity event – or fail – before the 15 year mark. Accordingly, we think something closer to 7 years would be appropriate. This would also be consistent with the period for which records are generally kept. At some point it will become difficult for employers, employees and Inland Revenue to keep track of the fact that an employee has a contingent tax liability with respect to shares the employee has owned for many years. We are interested in submitters’ views on this point.

### **Takeovers and restructures**

- 6.20 In the absence of specific rules, a corporate takeover or restructure of a company could have unintended consequences for employees with employee share scheme benefits.

- 6.21 In Australia rules are in place so that when the company offering the ESS has been subject to a takeover or restructure, any employee share scheme interests in a company that was acquired in connection with the takeover or restructure are treated as a continuation of the old interests. This is only to the extent that, as a result of the arrangement or change, the employee has ceased holding the old interests, and the new interests can reasonably be regarded as matching the old interests.
- 6.22 The Bill provides rollover relief where a person's ESS rights are cancelled and replaced with rights in a different scheme. The value of the replacement rights is not included in the person's income arising due to the cancellation of the original scheme. The benefit provided by the replacement scheme will be taxed appropriately by applying the proposed new rules to that scheme. Officials consider that the rollover relief provisions in the Bill are sufficient to deal with any unintended consequences resulting from takeovers or restructures.

### **Submission points**

We are interested to hear from readers:

- Whether they agree with each of the tax point events identified.
- Whether there are practical difficulties with any of these events.
- Whether there are other events that should trigger a tax liability.
- Whether there should be a sunset period and, if so, how long it should be?



## CHAPTER 7

### Employer deductions

- 7.1 The amendments in the Bill provide a deduction for employers for providing employee compensation in the form of shares, just as they can claim a deduction for other types of remuneration. This is consistent with the overall policy goal of neutral treatment between different forms of remuneration. Failing to provide a deduction for remuneration by way of shares similar to that available for remuneration in cash could discourage the use of ESS.
- 7.2 This deduction reflects the economic reality that the issue of shares for less than full market value involves a cost to the other shareholders in the company (as it dilutes their interests).
- 7.3 The same principle should apply to employers who provide shares to employees under a deferred ESS.

#### Timing of deduction under a statutory deferral regime

- 7.4 Under a deferral regime, the employee is the economic owner of the shares at an earlier point in time than when tax is payable. To address the practical issues of valuation and liquidity, the employee becomes taxable (in most cases) upon the satisfaction of a liquidity event, when the shares are more easily able to be valued, and they become converted or convertible into cash with which to pay the tax.
- 7.5 The question then arises as to whether the deduction should arise for the employer at the usual taxing point or at the deferred taxing point.
- 7.6 From a revenue collection perspective, the same considerations that mean the Government is indifferent between taxing the employee at the usual or deferred taxing point also apply in relation to the deduction.
- 7.7 However, if the employee is paying tax on a deferred basis, allowing a deduction at the usual time presents an increased collection and audit risk. The Government would be allowing a deduction to the employer with no guarantee that the employee would return the corresponding income in what might be a substantially later year. This risk is greater if the deferred taxing point can be extended past the employee leaving employment.
- 7.8 A further argument for deferring the deduction to when tax is payable, is that the same valuation issues for employees apply to the employer. It may not be possible for the employer to calculate the amount of the deduction.
- 7.9 As discussed above, employers may also prefer to defer their deduction. This is because start-up companies often generate significant, unusable tax losses in their early years of operation, only to forfeit these losses when third party investors buy a stake in the company (because they lose shareholder continuity at that point). It is also at this point in time when companies are

likely to be generating a net profit and would benefit from the earlier carried forward losses to reduce their current year tax bill. Therefore, it seems advantageous to the company to defer the deduction until the deferred taxing point, as well as sensible from a revenue perspective.

7.10 In Australia, generally deductions for tax deferred schemes are also deferred to when the employee receives the employee share scheme benefit.

7.11 In light of these considerations, if a deferral regime is introduced, we propose that deductions be deferred until income is recognised by the employee.

**Submission point**

We are interested to hear from readers whether they agree that employer deductions should also be deferred in relation to shares offered under a deferred employee share scheme.

## CHAPTER 8

### Administration and compliance

- 8.1 A statutory deferral option for start-up companies presents design issues which will need to be addressed in order to ensure compliance without imposing undue costs for employers, employees and Inland Revenue.
- 8.2 There is a range of options that could be implemented, with varying levels of compliance burden for taxpayers. For example, at one end of the spectrum, the regime could require Inland Revenue to hold the shares subject to the employee share scheme, and these would only be released to the employee (and the employer would only be entitled to a deduction) once the tax was paid.
- 8.3 At the other end of the spectrum, the regime could be entirely self-assessed by employers and employees.
- 8.4 A middle ground would be a regime which is self-assessed but with obligations on employers and/or employees to provide certain information to Inland Revenue about employee share scheme benefits subject to the deferral regime.

### Notification

- 8.5 Prior to 1 April 2017, there were no specific reporting requirements for employers offering, or employees participating in, ESS. From 1 April 2017 as a result of amendments in the Taxation (Transformation: First Phase Simplification and Other Measures) Act 2016, employers have an obligation to determine the amount of their employees' ESS income and report it monthly as part of the EMS.
- 8.6 However employers are not required to provide specific details of the share scheme benefits provided.
- 8.7 The administration of the statutory deferral regime would be aided greatly by taxpayers providing Inland Revenue with information in relation to the scheme. For example:
- What is the structure of the ESS that has been offered to employees (is it an option scheme, shares scheme, loan-funded share schemes)?
  - Which shares are subject to the deferral regime (if more than one scheme is operated if on a scheme-by-scheme basis or the election is on an employee-by-employee basis)?
  - Which shares subject to the deferral regime are still to reach a taxing point?
  - Which shares have reached a taxing point and, for these shares, the assessable income arising to the employee at that time (if any)

(recognising that this information should already be included in the EMS – albeit as part of an aggregate figure)?

- 8.8 If an additional level of reporting were required for a start-up deferral scheme, this could be reconciled with the EMS reporting so there is not a duplicate reporting obligation.
- 8.9 The obligation to report this information to Inland Revenue could fall on either employers or employees. Alternatively, the obligation to report could be imposed on someone who has no financial interest in the ESS, such as a scheme trustee. However, a requirement for a trustee does not sit well with the concept that deferral would be used primarily by start-up companies, which will generally wish to minimise overhead costs and thus would be less likely to employ the services of a professional trustee.

***Requiring employers to report***

- 8.10 Some submitters have previously suggested that if a deferral scheme is adopted, then employers should have the obligation to report to Inland Revenue in relation to the scheme.
- 8.11 This is because employers are better placed to design the scheme terms and conditions to ensure they can control when the deferred taxing point occurs and that they have the necessary information to fulfil reporting obligations. Employers are also likely to have greater resources at their disposal to manage the collection of the relevant information.
- 8.12 Further, it would be more efficient to impose compliance cost on one employer who can provide employee share scheme information for a number of employees, than to impose those compliance costs on each individual employee. As employers will already have to report some employee share scheme information as part of the EMS under the new rules on the collection of tax on ESS, it would make sense for employers to have all of the reporting obligations.

***Requiring employees to report***

- 8.13 Employees themselves could personally be responsible for reporting certain ESS information to Inland Revenue, and be required to notify Inland Revenue when certain events have occurred (for example, when they have elected to defer, or when they have sold or transferred their shares).
- 8.14 However, as noted above, generally employers are more able to efficiently bear compliance costs than employees. Filing returns and paying tax directly to Inland Revenue imposes compliance costs on employees, more so if they are unused to the process. These compliance costs could affect voluntary compliance and perceptions about the integrity of the tax system. From Inland Revenue's perspective, if an individual employee does not return the income from an ESS, the Commissioner has to expend resources to collect a potentially small amount of tax from that individual.

**Submission point**

We are interested to hear from readers:

- What kind of reporting and record keeping requirements would be necessary and appropriate to ensure that income and deductions from tax deferred share schemes is appropriately returned, and tax is paid?



## CHAPTER 9

### Research and development loss cash-out

- 9.1 Research and development (R&D) start-up companies are able to receive a payment for up to 28 percent of their tax losses from R&D expenditure in any given year. We refer to losses in respect of which a refund has been received as “cash-out losses”. These rules may not operate correctly when an R&D start-up company’s costs include ESS expenditure.
- 9.2 A cash-out loss can be thought of as an interest-free loan from the Government, to be repaid from the taxpayer’s future income; it is intended to provide a cashflow timing benefit only. The rules focus on start-up companies engaging in intensive R&D, and are intended to reduce their exposure to market failures and tax distortions arising from the general tax treatment of losses.
- 9.3 Companies that qualify for the existing R&D loss cash-out may also be offering ESS to their employees and may qualify as a start-up company under the criteria considered in this issues paper.
- 9.4 When the R&D loss cash-out was introduced for the 2015–16 and later income years, expenditure on ESS was not explicitly deductible to employers and the R&D loss cash-out rules do not specifically cover ESS expenditure.
- 9.5 The interaction between the two sets of rules primarily arises in the definitions of “total labour expenditure” and “total R&D labour expenditure” in section MX 3(3). These definitions include salary or wages of the employee as well as other costs such as contractor R&D consideration and certain payments to shareholder-employees.
- 9.6 ESS costs are not included within the definition of salary or wages so will not currently be included in the definition of total labour expenditure or total R&D labour expenditure.
- 9.7 Where the costs of ESS are not yet deductible because the taxing point has been deferred, these costs should not be included in the R&D loss cash-out calculations.
- 9.8 If the taxing point has occurred so that ESS costs are deductible but these amounts are not included in salary or wages this could have two impacts on eligibility for or amount of the R&D loss cash-out:
- Where ESS benefits are provided to employees who undertake R&D in a greater (lesser) proportion than other employees this will reduce (increase) the ability to meet the wage intensity criteria.
  - Where ESS benefits are provided to employees who undertake R&D these costs will not be included in the cap on the maximum R&D loss

cash-out at 1.5 times the employer's total R&D labour expenditure multiplied by the company tax rate.

### **Wage intensity criteria**

- 9.9 The wage intensity criteria requires that R&D labour expenditure is at least 20 percent of total labour expenditure. The purpose of this restriction is to ensure the R&D loss cash-out is targeted at firms that undertake sufficient intensity of R&D as a proportion of their overall activities.
- 9.10 As the inclusion or exclusion of ESS will affect both the numerator and denominator there will be no effect on the wage intensity calculation if ESS are provided to employees conducting R&D or not conducting R&D in equal proportions to all other remuneration.
- 9.11 However, certain employees may receive a greater proportion of their remuneration via ESS than other employees in the same company. This would affect the company's ability, either positively or negatively, to access the cash-out.

### **R&D loss tax credits**

- 9.12 The amount of cash-out available to an eligible company is capped at the lower of a number of separate calculations; one of which is 1.5 times the total R&D labour expenditure multiplied by the company tax rate.
- 9.13 If costs of ESS are not included within the R&D labour amount then the amount of cash-out available may be lowered by up to 42 percent<sup>8</sup> of those ESS costs. As ESS is a deductible labour expense of the company, this does not seem appropriate.

#### **Example 3: Current R&D treatment of ESS costs**

Start-up Co has been established during the 2018–19 year to develop an innovative new product. In the 2018–19 year it has no sales but incurs \$100,000 of cash wages, \$200,000 of other cash deductible costs and provided shares to its employees which have been independently valued at \$150,000. 90 percent of the cash costs meet the definition of "R&D expenditure" but only 40 percent of the ESS costs do as the majority are given to an employee who does not undertake R&D.

Start-up Co has made a tax loss of \$450,000 for the 2018–19 year. Its wage intensity calculation is  $\$90,000 \div \$100,000 = 90\%$  so it meets the wage intensity criteria for an R&D loss cash-out.

The maximum amount of the cash out for the 2018–19 year is the lesser of:

- $\$1,100,000 \times 28\% = \$308,000$
- Net loss for the year =  $\$450,000 \times 28\% = \$126,000$
- Total R&D expenditure =  $((\$100,000 \times 90\%) + \$200,000 + (\$150,000 \times 40\%)) \times 28\% = \$98,000$
- R&D labour expenditure =  $1.5 \times (\$100,000 \times 90\%) \times 28\% = \$37,800$

Start-up Co is entitled to an R&D loss cash-out amount of \$63,000

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<sup>8</sup>  $1.5 \times 28\%$ .



## Proposal

- 9.14 To address both these issues officials propose that ESS costs, if they meet the other requirements, be specifically included within total labour expenditure and total R&D labour expenditure for the purposes of the R&D loss cash-out rules. This will allow companies entitled to the R&D loss cash-out to receive a tax refund under that scheme which may be able to be used to fund a substantial part of the employee's tax liability on ESS benefits.

### Example 4: Proposed R&D treatment of ESS costs

Using the same facts from example 3 Start-up Co applies the proposed changes to the R&D loss cash-out.

Start-up Co has made a tax loss of \$450,000 for the 2018–19 year. Its wage intensity calculation is  $(\$90,000 + \$60,000) \div (\$100,000 + \$150,000) = 60\%$  so it meets the wage intensity criteria for an R&D loss cash-out.

The maximum amount of the cash out for the 2018–19 year is the lesser of:

- $\$1,100,000 \times 28\% = \$308,000$
- Net loss for the year =  $\$450,000 \times 28\% = \$126,000$
- Total R&D expenditure =  $(\$100,000 \times 90\%) + \$200,000 + (\$150,000 \times 40\%) \times 28\% = \$98,000$
- R&D labour expenditure =  $1.5 \times (\$100,000 \times 90\% + \$150,000 \times 40\%) \times 28\% = \$63,000$

Start-up Co is entitled to an R&D loss cash-out amount of \$63,000