CONSULTATION> OFFICIALS' ISSUES PAPER

Taxation of employee share schemes: start-up companies

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An officials' issues paper

Inland Revenue
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Taxation of employee share schemes: start-up companies

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https://www.taxpolicy.ird.govt.nz/consultation/2025/consultation-on-employee-share-scheme-timing-issues

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CHAPTER 1

Background

1.1 This consultation document updates an officials' issues paper that was released in May 2017.[1] It examines 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). Deferral would apply to both the timing of the tax obligation and the calculation of the income.

1.2 ESS are a useful way of incentivising and remunerating employees in New Zealand and internationally.[2] 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 current law is to ensure that the taxation of ESS benefits is consistent with the taxation of cash remuneration.

1.3 In May 2017, officials released a paper consulting on a possible deferral regime. At the time there was relatively little reaction to the paper, and the proposal did not proceed. More recently, there have been calls from some in the start-up sector for the issue to be revisited.[3] In the recent 2023 Upstart Nation report, the timing of taxation for ESS was identified as one of the main issues for founders of start-up businesses.

1.4 The Government is particularly interested in reviewing the ecosystem for start-up tech companies, recognising that they can be significant generators of economic growth. This paper is an update of that earlier paper. The objective remains the same, to determine through consultation whether a deferral regime can be developed that would be of value, and how to ensure it is fair and commercially attractive.

1.5 The release of this officials' issues paper is an attempt to test whether there is appetite for a deferral regime and, if so, how one might operate in practice. Any feedback received will be considered and weighed against other Government priorities.

1.6 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 or losses on the shares until the deferral taxing point occurs. This is a cost because any increase in the value of the shares between the usual (non-deferred) taxing point and the deferred taxing point would otherwise be a tax-free capital gain, in most cases. Of course, when the shares decline in value between those two points in time, deferral will result in less tax for the employee.

Taxation of ESS income in Income Tax Act 2007

1.7 The amendments in the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018 (the 2018 Act) ensure that employees are taxable on shares received in connection with an ESS once

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[1] Taxation of employee share schemes: start-up companies, Inland Revenue (May 2017).

[2] In the 2022 year, employers reported providing $533 million of taxable ESS benefits to 15,730 employees.

[3] This includes recommendation 12 in UpStart Nation, Ministry of Business, Innovation and Employment (August 2023).

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 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 2018 Act 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.

1.8 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.
- When 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

1.9 Taxing share benefits is problematic when 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 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.

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

- the scope of the deferral measure
- the nature and timing of any election for deferral
- when the tax imposed should arise under the deferral scheme (ie, a "liquidity event")
- timing of deductions for the employer, and
- matters of administration and compliance.

Interaction between R&D loss cash-out and ESS rules

1.11 In Chapter 9 we discuss the interaction of the ESS start-up proposals and the existing research and development (R&D) loss tax credit regime and propose to ensure that ESS costs to the employer are appropriately dealt with under that regime.

1.12 Feedback on this issues paper will be used to help shape recommendations to the Government.

How to make a submission

1.13 Officials invite submissions on the proposals in this document, including on the specific questions asked and any other issues raised in the document.

1.14 Include in your submission a brief summary of the major points and recommendations you have made. Please indicate if officials from Inland Revenue can contact you to discuss the points raised, if required.

1.15 The closing date for submissions is **14 March 2025**.

1.16 Submissions can be made:

- by email to policy.webmaster@ird.govt.nz with "Possible changes to taxation rules for start-up and tech sector" in the subject line, or
- by post to:

  Taxation of employee share schemes: start-up companies
  C/- Deputy Commissioner, Policy
  Inland Revenue Department
  PO Box 2198
  Wellington 6140

1.17 Submissions may be the subject of a request under the Official Information Act 1982. Please clearly indicate in your submission if any information should be withheld on the grounds of privacy, or for any other reason (contact information such as an address, email, and phone number for submissions from individuals will be withheld). Any information withheld will be determined using the Official Information Act 1982.

CHAPTER 2

Valuation and liquidity issues for start-up companies and their employees

2.1 If the tax on income received in the form of an ESS benefit arises without a sale or an active market for the relevant shares, and when there may be little or no earnings history or realisable assets, it is difficult to determine the shares' value to work out the tax liability. Furthermore, 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 – making the scheme less attractive. The employer can 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.

2.2 Another liquidity issue that can arise is when the shares are in a non-resident company. Once the employee is the owner of the shares for tax purposes, the employee will often be subject to tax on the shares under the foreign investment fund (FIF) regime. The FIF regime often deems income to arise in the absence of cash, for example, if the shares are subject to the fair dividend method in the FIF regime.

Valuation

2.3 Under the current law, 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 this 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 valuation guidelines for shares received by an employee under an ESS.[4] There are specific valuation guidelines that apply to an unlisted start-up company (which is defined later in this paper). In the event there has not been a recent issue or sale of the same class of shares, it is likely they will have to undergo an independent and qualified valuation exercise.

Liquidity

2.6 Start-up companies are also often cash constrained – all available cash is allocated to developing the business. This is one reason these companies use ESS 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 receive a modest cash salary to cover living costs and the rest of their remuneration in shares.

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[4] Commissioner's statement CS 24/01: *Determining the "market value" of shares that an employee receives under an employee share scheme*.

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, even that 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 liquidate 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.[5] Officials recognise the case for considering ways to reduce the difficulty of meeting a tax cost from receipt of illiquid shares.

2.9 Another issue submitters have raised as an obstacle to the take-up of ESS is the application of the FIF regime, and in particular the imposition of tax under the fair dividend rate or cost methods. These methods will often give rise to income in the absence of cash flow, which can create a liquidity issue for the shareholder-employee.

Self-help solution – long-term options

2.10 Under current law, it is possible to legitimately structure an ESS 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.

2.11 For example, if an employee is given an option that expires in 20 years, the employee can use a "self-help" approach to 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. The FIF rules do not apply to share options so using options will also avoid the liquidity issues that can be associated with those rules.

2.12 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 because it aligns the employees' motivations with the company's motivations.

2.13 Submitters have 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 the International Financial Reporting Standards.

2.14 Therefore, submitters have said that, as a practical matter, many companies may not wish to take advantage of this self-help solution.

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[5] All references to "submitters" are from those who provided public feedback into a wider issues paper on the taxation of employee share schemes (*Taxation of employee share schemes: An officials' issues paper*, Inland Revenue (May 2016)).

CHAPTER 3

Deferral regime and other options for supporting start-ups

Deferral regime

3.1 This issues paper, like the May 2017 issues paper, is principally seeking submissions on the desirability of a regime that would allow for deferred 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 to satisfy the tax liability.

3.3 Deferral of taxation yields an eventual after-tax outcome for the employee that is equivalent to upfront taxation (ie, no deferral) provided the change in value over the deferral period would not, in the absence of deferral, be taxed. 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 idea 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 in the company. Suppose the share value increases by a factor of 10 between the investment date and the date when the employee sells them. Assume a 39% tax rate.

Tax at issue

Tax of $39 is paid upfront, leaving an after-tax amount of $61 to be invested in shares in the company. The value of the shares goes up 10 times to $610.

Deferred tax

No tax is paid upfront and $100 is invested in shares in the company. The value of the shares goes up 10 times to $1,000, and tax of $390 is paid when the shares are sold, leaving the same net position of $610.

Conclusions

Tax at issue and deferred tax at sale are equivalent, assuming that in the case of tax at issue, there is no tax on the subsequent gain in value.

Reducing the amount invested by 39% upfront is equivalent to reducing the proceeds by 39% at the end.

The small amount of $39 upfront leaves the employee in the same net position as the large amount of $390 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 any increase in value after the IPO would in most cases be tax-free capital gains.

Example 2: Deferral of tax on exercising options

An employee of a New Zealand company 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. There is no secondary market for the shares, so 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 because the shares are held as a capital asset.

Forfeiture of tax losses for employers

3.5 Previously, start-up companies would generally generate unusable tax losses in their early years of operation, only to forfeit these losses when third party investors would buy a stake in the company (because they lose shareholder continuity at that point). However, a recent reform has loosened the loss continuity rules. The business continuity test allows companies to carry forward losses even if they do not meet the requirements of the shareholder continuity test. This test applies provided there is not a major change in business within five years following a change in ownership. This makes it more likely that a start-up employer will be able to benefit at some point from deductions arising from providing ESS benefits.

Other possibilities

3.6 In addition to the deferral regime proposal, there are at least two other approaches that could be taken to deal with the issues faced by start-up companies: exempting the income and denying a deduction; or cashing out the ESS deduction in the case of a loss-making company.

Non-deductible and non-assessable approach

3.7 Exempting the income and denying a deduction is the approach taken for widely offered share schemes that meet certain requirements and make the necessary election. 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, when the employer is in tax loss. As to the first of these, the current margin is 11%, which is material. 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. Accordingly, we do not propose to extend this treatment beyond the ambit of the widely offered schemes, noting two thresholds are proposed to be extended as part of the Taxation (Annual Rates for 2024−25, Emergency Response, and Remedial Measures) Bill.[6] Officials believe the deferral proposal is a preferable solution to the issues faced by loss companies.

Cashing out losses

3.8 A second approach would be to cash out the ESS deduction in the case of a loss-making company. This would provide the company with most of the money required to pay grossed-up PAYE or a cash gross-up paid to the employee. However, it would be a significant departure from our current taxation of employment remuneration. Currently, losses can be cashed out only when 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.

Questions for submitters

- Do submitters think a deferral regime would be attractive to employers and employees? If not, can you outline any potential issues?
- Is there any alternative arrangement that would be attractive to start-up employers and employees that would not result in under-taxation?

[6] The proposed amendments would increase the maximum market value of the shares provided from $5,000 to $7,500 a year, and the maximum benefit that can be provided from $2,000 to $3,000 a year.

CHAPTER 4

Scope of deferral regime

4.1 Our proposal is to restrict the availability of the deferral regime to "start-up" companies (as defined).

Rationale for a narrowed scope

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 so 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; and
- are more likely to have an earnings history or tangible assets that can be used to the value of the company.

4.5 Start-ups, and particularly those in the tech sector, are especially affected by 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.

Defining "start-up companies"

4.6 There are difficulties associated with defining a "start-up company". In Australia's start-up concession for ESS, a "start-up company" is, broadly speaking:[7]

- an unlisted Australian company;
- less than 10 years old; and
- with annual turnover of less than AU$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 AU$1 more than AU$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 margins. For example, a company might 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 that clearly excludes

[7] Section 83A-33, Income Tax Assessment Act 1997 (Australia).

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 $15 million per annum, reflecting the level 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 that 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 to qualify for the deferral regime. Instead, or as well as an asset threshold, legislation could list a number of activities that would disqualify a company from the deferral regime. For example, section CW 12 of the Income Tax Act 2007 (ITA) 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.[8]

4.10 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.

Questions for submitters

- Do you 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 a listed company)?
- 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 and why?
- What other thresholds or indicators might be appropriate (including whether or not the company has paid a dividend)?

[8] Section CW 12 of the ITA 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.

CHAPTER 5

Deferral measure – elections

5.1 This paper is seeking submissions on whether the proposed taxing point deferral should be elective or mandatory.

5.2 For a regime based on an elective deferral, feedback is also sought on:

- who should make the election;
- when the election should be made; and
- whether the election should be on a scheme-by-scheme or employee-by-employee 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, it should not 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 in advance 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.

Scheme-by-scheme elections versus employee-by-employee

5.8 It would seem simpler for the election to be made on a scheme-by-scheme basis. 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. If a requirement for a deferral scheme ceases to be met, we suggest that the scheme should cease to offer shares. This may reduce confusion about the tax treatment of benefits offered under a scheme. Once a scheme offers deferred benefits, any benefits offered under that scheme would be deferred benefits.

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, but it may be more challenging to keep track of whether a benefit provided to a particular employee should be taxed at the usual time or on a deferred basis.

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 to participate in or offer a qualifying deferred taxation scheme. This 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 to make it easier for employers to comply with their reporting requirements.

Questions for submitters

- Should any deferral regime for start-up companies 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 to a third party, these issues have been resolved, so tax should be payable no later than that time.

6.3 Sale of the shares can trigger the taxing point under existing law. However, the likelihood of sale being the relevant taxing event is much higher when there is a deferred taxing point than it is under current law. In addition, there are other events that should also potentially trigger the taxing point for shares under a deferral regime – either because the liquidity and valuation issues have been resolved, or there are important integrity reasons for tax to be triggered.

6.4 In this chapter we first discuss the challenges presented by sale as a taxing point in the context of a deferral regime. We then consider the additional events that could trigger a "liquidity event".

Sale as a taxing point

6.5 The obvious starting point for a "liquidity event" is when the shares are sold. At the time the shares are sold the employee will have money available to satisfy the tax liability. This would also address the valuation issue given the shares have a price point for which they are sold.

6.6 The employer reporting requirement for ESS benefits may be challenging when the taxing point for an ESS benefit is determined by a sale of the shares by an employee to a third party. It may be difficult for a company to know that such a sale has occurred, and for what price the shares were sold.

6.7 Provided listing the shares also triggers the taxing point, these challenges only need to be addressed for an unlisted company. Knowledge of the transaction itself may not be so problematic in that case, since the transfer will generally be notified to the company or its agent for the purchaser to be recognised as the shareholder.

6.8 A difficulty that could arise is if the employee owns both shares subject to the deferred taxing rule and other shares of the same class. In that case the tax liability may depend on which shares are treated as being sold. Given that shares are generally fungible, this will require a cost-flow assumption such as first-in, first-out (FIFO) or last-in, first-out (LIFO).

6.9 Submissions are welcomed on whether this issue should be addressed and if so how. One possibility is that the shares sold could be deemed first to be the shares subject to the deferred taxing point. Another option is provided by section ED 1(5) of the ITA, which gives shareholders a choice of a FIFO or weighted average cost cost-flow method.

6.10 As to the sale price, this would not necessarily be known by the company. It is proposed that employees have a statutory duty to inform their employer of the amount for which they have sold shares subject to an ESS when the taxing point is triggered by the sale. If they do not inform the employer within a specified time frame, the employer could be entitled to treat the shares as sold for a reasonable estimate of market value.

Other deferred taxing points

6.11 In addition to the sale of the shares, the following events are proposed to also trigger the taxing point:

- an initial public offering (IPO) of the shares on a recognised exchange;
- cancellation of the shares, including on the company being struck off (this will be a relatively common occurrence for start-up companies);
- the employee ceasing employment with the employer, or ceasing to be a New Zealand tax resident;
- a "sunset" date, for example, recognition of income cannot be delayed by more than seven years**.**

6.12 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 as employment information. 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 in relation to the option.

Winding up

6.13 A start-up may provide a return to its shareholders by selling the company's assets to a third party. The start-up would then distribute the sale proceeds (often cash or shares in the acquiring company) to its shareholders in a liquidation.

6.14 Our proposal is that the final distribution triggers the taxing date in this situation.

6.15 An issue that may assume more significance in this context than in the case of a dividend paid by a continuing company is the effect of ESS income on the available subscribed capital (ASC) of the employee's shares. As a general proposition, the ASC resulting from a particular issue of shares is not attributed to those particular shares. Instead, it goes into the ASC pool for the share class. This is a practical rule, but it can lead to some shareholders being undertaxed (because part of their economic return is treated as a return of capital) while others are overtaxed. That may seem particularly problematic if the return of capital occurs very shortly after the share issue. Nevertheless, officials propose that in the interests of simplicity there be no special rule for this case.

Initial public offering

6.16 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.

6.17 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.

However, Commissioner's statement CS 24/01 on the valuation of ESS shares only allows sale value to be used if sale is on the day of the IPO. The Australian approach may be problematic in New Zealand due to our employment information reporting requirements, and the availability of an employer deduction.

6.18 The deduction will arise immediately after the IPO so the employer's deduction will not be affected by any IPO-related ownership changes that otherwise might see the employer forfeit previously carried forward tax losses from unused ESS deductions. This is another advantage of deferring the taxing point.

Cancellation of shares

6.19 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 employee

6.20 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 around whether these now former employees will comply with their obligations.

6.21 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 that is subject to PAYE.

6.22 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.

6.23 If employees did not trigger the taxing point upon leaving employment, former employees would continue to be required to return tax on the ESS benefit even though they were no longer employed by the company. The company would need to be able to identify the taxing point to correctly report employment information, and to calculate its deduction.

Ceasing to be New Zealand tax resident

6.24 Collection of tax might be easier if the former employee continues to be a New Zealand tax resident.

6.25 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 other sections of the ITA when a liability is crystallised at the point the person ceases to be a New Zealand tax resident, though it is not consistent with the treatment of unexercised ESS options.

Sunset period

6.26 A finite date at which deferral lapses prevents the start-up rules allowing an indefinite deferral of tax liability. For instance, in some jurisdictions, bespoke financing packages are available to allow employees in successful start-ups to monetise the value of their ESS benefits without triggering a taxing point, thus avoiding tax permanently on the ESS benefits. To prevent this, it is proposed that there be a "sunset" period. When this period expires, the taxing point will be triggered regardless of whether one of the other events has occurred.

6.27 The Australian rules include a "sunset" period of 15 years (recently extended from seven 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.

6.28 Data from Statistics New Zealand shows that slightly more than 50% of businesses fail within four years, 65% fail within seven years and 80% fail within 15 years. A seven-year sunset period is suggested to 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.

Takeovers and restructures

6.29 In the absence of specific rules, a corporate takeover or restructure of a company could have unintended consequences for employees with ESS benefits.

6.30 In Australia, rules are in place so that when the company offering the ESS has been subject to a takeover or restructure, any ESS interests in a company that are 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.

6.31 The ITA provides rollover relief when 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 ITA are sufficient to deal with any unintended consequences resulting from takeovers or restructures.

Questions for submitters

- Do you agree with each of the tax point events identified?
- Are there examples of any practical difficulties with any of these events?
- Are there other events that should trigger a tax liability?
- Should there be a sunset period and, if so, how long it should be?

CHAPTER 7

Employer deductions

7.1 The Income Tax Act 2007 provides 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 because 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 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 easier to value, 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 neutral on 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 valuation, collection and audit risk. As to valuation, the amount of the deduction to the employer will be determined at a different time, often when valuation is less certain. There is therefore a risk of systemic undervaluation. In addition, the Government would be allowing a deduction to the employer with no guarantee that the employee would return the 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 In Australia, generally deductions for tax deferred schemes are also deferred to when the employee receives the ESS benefit.

7.9 In light of these considerations, if a deferral regime is introduced, it is proposed that deductions be deferred until income is recognised by the employee.

Practical difficulties

7.10 An employer would be aware of most of the proposed taxing points referred to in Chapter 6, eg, liquidation of the company, a restructure or an IPO. However, the employer might not be aware of:

- a sale of the shares by the employee; or
- the employee ceasing to be New Zealand tax resident, particularly if no longer employed by the company.

7.11 These problems have been raised in other chapters of this paper.

Questions for submitters

- Do you agree that employer deductions should also be deferred in relation to shares offered under a deferred ESS?
- What practical difficulties might there be for employers in identifying the deferred date, for example, if it is triggered by an employee selling shares or becoming non-resident?

CHAPTER 8

Administration and compliance

8.1 A deferral option for start-up companies presents design issues that will need to be addressed to ensure compliance without imposing undue costs on employers, employees and Inland Revenue. In particular, the proposal might make it more difficult for employers to identify the taxing point, which might lower compliance.

Notification

8.2 Under current law, employers have an obligation to determine the amount of their employees' ESS income and report it to Inland Revenue either every payday or twice monthly as part of their employment information (EI). Non-filing taxpayers then receive a notice of their tax payable on the ESS benefit automatically. Filing taxpayers (the majority of employees receiving ESS benefits), are notified of the amount of the ESS benefit and are then obliged to include it in their return. This system appears to be working to achieve a good level of compliance.

8.3 However, employers are not required to provide specific details of the share scheme benefits provided.

8.4 The integrity of any deferral regime might be improved by employers 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, share scheme, loan-funded share scheme)?
- 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 EI reporting)?

8.5 If an additional level of reporting were required for a start-up deferral scheme, this could be reconciled with the EI reporting so there is no duplicate reporting obligation.

8.6 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 that will generally wish to minimise overhead costs and would be less likely to employ the services of a professional trustee.

Requiring employers to report and pay tax

8.7 Employers already have to report ESS information as part of the EI so it would make sense for employers to have all reporting obligations for any deferral scheme.

8.8 On the other hand, there is an argument that some of the aspects of a deferral scheme make employer reporting more difficult. If the taxing event is triggered by a sale of shares or an employee ceasing to be New Zealand resident, the employer may not be aware that event has taken place. Requiring reporting in relation to persons who are no longer employees is already a challenge, for example in relation to option schemes when the employee leaves employment before exercising the option.

Additional challenges

8.9 A deferral scheme may present additional compliance challenges. By deferring the time for calculation and payment of the tax:

- it is possible that the amount owed by an employee is larger than it would otherwise be;
- it is more likely that the employer will **not** know about the event that has given rise to the tax and therefore the employer will not be able to report it.

Questions for submitters

- 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?
- What additional compliance challenges might arise and how these could be dealt with?

CHAPTER 9

Research and development loss cash-out

9.1 Research and development (R&D) start-up companies can receive a payment for up to 28% of their tax losses from R&D expenditure in any given year[9]. We refer to losses in respect of which a refund has been received as "cashed-out losses". These rules may not operate correctly when an R&D start-up company's costs include ESS expenditure.

9.2 A cashed-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) of the ITA. 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 When 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:

- When 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.
- When 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% of total labour expenditure. The purpose of this restriction is to ensure the R&D

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[9] The credit is provided for in subpart MX of the ITA.

loss cash-out is targeted at firms that undertake sufficient intensity of R&D as a proportion of their overall activities.

9.10 The inclusion or exclusion of ESS expenditure will affect both the numerator and denominator so there will be no effect on the wage intensity calculation if ESS benefits 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 ESS costs are not included within the R&D labour amount, then the amount of cash-out available may be lowered by up to 42% of those ESS costs. ESS is a deductible labour expense of the company so this does not seem appropriate.

Example 4: Current R&D treatment of ESS costs

Start-up Co has been established during the 2022−23 year to develop an innovative new product. In the 2022−23 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% of the cash costs meet the definition of "R&D expenditure" but only 40% of the ESS costs do because 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 2022−23 year. Its wage intensity calculation is $90,000 ÷ $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 2022 and subsequent years is the lesser of:

- $2,000,000 x 28% = $560,000
- net loss for the year = $450,000 x 28% = $126,000
- total R&D expenditure = (($100,000 x 90%) + $200,000 + ($150,000 x 40%)) x 28% = $98,000
- R&D labour expenditure = 1.5 x ($100,000 x 90%) x 28% = $37,800.

Start-up Co is entitled to an R&D loss cash-out amount of $37,800.

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 that may be able to be used to fund a substantial part of the employee's tax liability on ESS benefits.

Example 5: Proposed R&D treatment of ESS costs

Using the same facts from Example 4, 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 2022−23 year. Its wage intensity calculation is ($90,000 + $60,000) ÷ ($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 2022 and subsequent years is the lesser of:

- $2,000,000 x 28% = $560,000
- net loss for the year = $450,000 x 28% = $126,000
- total R&D expenditure = (($100,000 x 90%) + $200,000 + ($150,000 x 40%)) x 28% = $98,000
- R&D labour expenditure = 1.5 x ($100,000 x 90% + $150,000 x 40%) x 28% = $63,000.

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