



Tax treatment of employee share schemes – further consultation

On 12 May 2016, officials released an issues paper, [Taxation of employee share schemes](#). Twenty-seven submissions were received. These submissions, and discussions with many of the submitters, have assisted us considerably in the policy formation process. The purpose of this paper is to provide an update on the proposals, and the opportunity to make a further submission on the updated proposals if you would like to do so.

Summary

In summary, following submissions our proposals are as follows:

- *Taxation of employees:* The principles on which our proposals are based have not changed. However, we do want to clarify that an obligation placed on an employee to transfer an employee share scheme share for market value will not defer the taxing point. It may also be that the concept of economic ownership is a better description of at least one aspect of our proposal.
- *Deduction for employers:* There is no change to our proposal that employers who provide employee share scheme (ESS) benefits should be entitled to a deduction that matches, in both timing and amount, the employee's income.
- *Start-up companies:* There was little support for the deferral proposed in Chapter 6 of the issues paper, and accordingly any benefits do not seem to be matched by the complexity that a deferral option would require.
- *Widely offered schemes:* We propose that there continue to be a concession for widely offered schemes, but propose also that numerous changes be made so that the schemes are less restrictive and simpler to operate.
- *Transitional/grandparenting:* We propose to extend transitional relief in a number of respects.

This paper expands on these proposals, and provides some examples of the application of the proposed new rules.

Submissions

Submissions on the updated proposals should be made by Friday **30 September 2016**, so that we can take these into account in our final advice to Ministers. Submissions can be emailed to policy.webmaster@ird.govt.nz or sent to:

Employee share schemes – further consultation
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

Taxation of employees

General

1. No change is proposed to the general thrust of the proposals (in Chapter 5 of the issues paper) in this respect. However, there is an important point of clarification. A requirement on an employee to transfer employee share scheme (ESS) shares for market value should not of itself require the deferral of recognition of income.
2. This section sets out the broad statutory tests that we propose, and then provide some examples of their operation. These rules reflect two important principles. They are that:
 - ESS benefits which depend on continued employment should be taxed once that employment has occurred;
 - ESS benefits which are options or subject to contingencies should be taxed once the option is exercised or the contingencies are resolved.

Benefits dependent on continued employment should be taxed once employment has occurred

3. Many submissions supported the continuation of the current taxing point, where employees are taxed once shares are held on their behalf by a trustee, regardless of whether the employee loses the shares if they leave their employment. They viewed any gain or loss in the shares after that point as a capital gain or loss.
4. We do not find this capital gain argument compelling, for the following reasons:
 - It ignores the fact that a person whose right to shares will be lost if they do not remain employed for a period is in a fundamentally different position from an ordinary investor. The employee has no entitlement to gain or loss on the shares until the period of service has been satisfied. The investor does have such an entitlement.
 - It creates an unjustifiable difference in tax outcomes between the tax treatment of an employee who receives a contingent interest in shares which is lost if they leave and an employee who has a right to receive shares if they stay.
 - It does not reflect an ordinary principle of income derivation, which is that income is taxed once it is earned.
 - Any payment in kind for employment services is taxed by reference to the value of the asset provided, at the time the asset is earned. If the value of the asset changes between the time the employment contract is entered into (or the time the asset is promised, if later) and the time the relevant services are provided, that change in value will affect the service provider's income. That does not mean that we are taxing capital gains.

5. Some submitters also supported the current taxing point on the ground that it reflects commercial reality. It was suggested that an employer, deciding whether to conditionally provide shares to an employee in the future, would consider the current market value of the shares – not the expected future value of the shares. Similarly, an employee would value the conditional offer based on the current value of the shares. Submitters argued it was therefore appropriate to tax the conditional offer of shares based on the value of the shares when the offer is made.
6. We are not convinced by this argument. The value an asset is expected to have in the future is not the same as its current market value (unless it pays out a cash return equal to its risk-adjusted rate of return). Shares are generally expected to increase in value over time (subject of course to their expected dividend payout). Therefore, an employee will in most cases value a conditional offer of shares in the future with a current value of \$10,000 more highly than a conditional offer of \$10,000 cash in the future. Taxing the shares based on their market value at the time of the offer would under-tax.
7. It could be argued then that employees should be taxed on the expected future value of the shares when they are promised – rather than the actual value of the shares when received. However, there would be valuation issues with this approach. Moreover, taxing an employee on the value of the shares when they earn them – rather than the value they are expected to have – is more equitable and more in accordance with the way other remuneration is taxed.

Options should be taxed on exercise

8. A number of submitters were in favour of taxing options on issue. An important point which may not have been appreciated by some of these submitters is that even if options are taxed “on issue”, consistent with the first principle discussed above, the taxing point would be deferred until the options vest, that is, there is no further service requirement.
9. We remain of the view that the current tax treatment of options should continue. Again, there are a number of reasons for this:
 - Option valuation is more contentious than share valuation.
 - Taxing the issue of options is more likely to tax in the absence of any immediate prospect of liquidity.
 - Taxing options on exercise taxes winners rather than losers.
 - Taxing on exercise and taxing on grant appear to result in the same after tax outcomes to employees in any case (see Example 3 on page 16 of the issues paper).

Proposed taxing point and amount

10. The test aims to identify the time at which an employee holds shares on the same basis as a non-employee shareholder. That is, the time when there are:

- no put or call options; and
- no downside or upside price protections,

except for those that:

- (a) would arise in the absence of the employment relationship; or
- (b) do not affect the employee's right to the economic ownership of the shares.

This time can be referred to as the "taxing point".

11. In addition, where the rights are subject to a possibility of change (for example, an option or a share, which can be reclassified if certain events occur), the taxing point will arise when there is no significant risk of further change.

12. Options, protections and changes which are triggered by events which do not have a real risk of occurring, or which for some other reason have no practical significance, will not be taken into account.

13. If a person sells their rights back to their employer or an ESS trust (or indeed to any third party) before the taxing point identified above, that sale will trigger the taxing point.

14. The amount of income will be the market value of the shares at the taxing point (or the sale price if the taxing point is triggered by sale), less any contribution required of the employee.

Example 1 – Simple vesting period

Facts

A Co transfers shares worth \$10,000 to a trustee on trust for an employee. If the employee leaves the company for any reason during the next three years, the shares are forfeited for no consideration. After three years, the shares are transferred to the employee.

Result

The taxing point is when the three years is up and the employee is still employed.

Analysis

The risk of loss of the shares for the first three years means the employee does not hold the shares on the same basis as a non-employee shareholder.

Example 2 – Vesting period with good leaver exception

Facts

As for Example 1, except that if the employee ceases employment because of death, illness, disability, redundancy or retirement within the three-year period (is a “good leaver”), they are entitled to the shares.

Result

The taxing point will be the end of the vesting period, or when the person leaves as a good leaver.

Analysis

There is a real risk that the employee will leave employment for some other reason than those listed (for example, a better opportunity presents itself) and therefore the risk of forfeiture is still relevant.

Example 3 – Vesting subject to misconduct

Facts

As for Example 1, except that if the employee ceases employment for any reason other than being subject to disciplinary action or committing some form of employment-related misconduct during the three-year period (i.e. being a “bad leaver”), the employee is entitled to the shares.

Result

The taxing point is when the shares are initially transferred to the trust, and the income will be their value at that time.

Analysis

The risk of the employee losing their job for these “bad” reasons during the three year period is not sufficiently substantial to require deferral.

Example 3A – Vesting subject to misconduct with accrual

Facts

As for Example 3, except that if the employee ceases employment for any reason other than being a bad leaver, they are entitled to only a pro rata portion of the shares based on completed years’ service (for example, nothing for the first year, one-third of the shares if the employee leaves between one and two years, etc.).

Result

There will be three taxing points – at the end of years 1, 2 and 3 respectively. The employee will be taxed at the end of each year on the value at that time of one third of the shares.

Analysis

Until the end of the first year, if the employee leaves for another job, they will not be entitled to any shares. Once the first year is completed, they will be entitled to one-third of the shares, provided they are not a bad leaver during the next two years. The risk that the employee will leave for another job is sufficiently real that it defers the taxing point. The risk that the employee will leave as a bad leaver is sufficiently unlikely that it does not defer the taxing point. The fact that the shares are held by the trustee until the end of year three does not of itself defer the taxing point.

Example 3B – Performance hurdles

Facts

As for Example 3A, except that the employee is not entitled to the shares at all unless a total shareholder return¹ hurdle (measured as an annual percentage) is also met. If the hurdle is met in year 1, one-third of the shares vest. If it is met in year 2, a further one-third of the shares vest. Also, if it was not met in year 1, but is met on a combined basis over years 1 and 2, a further one-third of the shares will vest. The same approach applies in year 3.

Result

There will be three possible taxing points – at the end of years 1, 2 and 3 respectively. The employee will be taxed at the end of each year on the value of the shares that vest at that time.

Analysis

Until the end of the first year, if the employee leaves for another job, they will not be entitled to any shares. Once the first year is completed, they will be entitled to retain one-third of the shares, provided they are not a bad leaver during the next two years, and provided the year 1 performance hurdle is met. The risk that the employee will be a bad leaver is sufficiently unlikely that it does not defer the taxing point. The fact that the shares are held by the trustee until the end of year 3 does not of itself defer the taxing point.

Example 4 – Vesting period, with compulsory sale for market value thereafter

Facts

As for Example 1, except that even after the three-year period ends, the trustee retains legal ownership of the shares, and the employee must transfer their rights back to the trustee or A Co when the employee leaves. However, once the three-year period is up, the employee will receive the market value of the shares when their beneficial ownership is transferred.

Result

As for Example 1.

Analysis

Once the three-year period has expired, the employer's or trustee's right to acquire the beneficial interest in the shares is for market value, and therefore the taxing point is not deferred.

¹ Annual "total shareholder return" is a combination of dividends paid and appreciation in share price during a year.

Example 5 – Insubstantial put option

Facts

As for Example 4, except that the employee has the right at all times to sell the shares back to the trustee for a total price of \$1.

Result

The taxing point would be the same as in Example 4.

Analysis

The employee's right to sell the shares for \$1 is not a right to sell the shares at market value, and therefore has the potential to defer the taxing point. However, at the time it is granted, there is no real risk that this option will be exercised, given that there is no liability attached to the shares and that they are then worth \$10,000. This right would therefore not be taken into account.

Example 6 – Loan funded scheme A

Facts

B Co provides an employee with an interest free full recourse loan of \$10,000 to acquire shares in B Co for market value, on the basis that:

- the shares are held by a trustee for three years;
- dividends are paid to the employee from the time the shares are acquired;
- if the employee leaves within three years, the shares must be sold back to the trustee for \$10,000, which must be used to repay the loan;
- if the employee is still employed by B Co after three years, the employee can either sell the shares to the trustee for the loan amount, or choose to continue in the scheme; and
- if the employee chooses to continue, the loan is only repayable when the shares are sold.

Result

The taxing point will be the earlier of when the employee leaves employment, or the expiry of the three years.

Analysis

Until the three years are up, B Co or the ESS trust has a right to acquire the shares for an amount that is not their market value. This right arises out of the employment relationship, and deprives the employee of the risks and rewards of ownership of the shares during that period. So the taxing point will on the face of it be when that period ends. If the employee leaves within the three-year period and is therefore required to transfer their rights, the sale price will be taxed, but since the sale price is the same as the amount contributed, there will be no gain or loss. Once the three-year period is up, the employee will either have no income (if they sell the shares back to the trustee for \$10,000) or will pay tax on the difference between the value of the shares at that time and their \$10,000 price (if they choose to keep the shares).

Example 7 – Loan funded scheme B

Facts

As for Example 6, except that:

- the loan is limited recourse for the first three years (i.e., during that period, the amount repayable is limited to the value of the shares at the time of repayment); and
- if the employee leaves within three years, or chooses at the end of the three years to sell the shares to the trustee, they must be sold back to the trustee for market value.

Result

As for Example 6.

Analysis

The limited recourse loan provides protection against a decline in the value of the shares. Accordingly the taxing point is the same as for Example 6 – that is, the end of three years (when the loan ceases to be limited recourse) or when the shares are sold to trustee. If the employee sells the shares for less than \$10,000 (because that is their market value), the employee will have a deductible loss from the scheme. They will have debt forgiveness income of an equal amount.

Example 8 – Loan funded scheme C

Facts

As for Example 6, except that:

- as in Example 7, the sale back to the trustee must be for market value, whenever it occurs;
- at the time of such a sale, the employer must pay the employee the amount of any decline in the value of the shares since the grant date.²

Result

As for Example 6.

Analysis

The employer's promise to pay a bonus equal to the decline in the value of the shares is a form of downside protection. If the employee sells the shares for less than \$10,000 they will have a deductible loss from the scheme, which will be equal to the income they will recognise due to the payment from the employer.

² This seems an unlikely scenario, but it was put to us in the course of submissions so we have dealt with it here.

Example 9 – Loan funded scheme D

Facts

As for Example 8, except that there is no arrangement for the employer to pay the employee the amount of any decline in value of the shares.

Result

The taxing point is when the agreement is entered into.

Analysis

From the time the agreement is entered into, the employee has the full risk and reward of share ownership.

Example 10 – Vesting only in the event of a sale or IPO

Facts

C Co transfers 1,000 shares to a trustee for an employee. The shares remain held on trust until the employee leaves, more than 50% of C Co is sold, or C Co is listed (whichever happens first). If the employee leaves first, the shares are forfeited. If more than 50% of C Co is sold, the employee's shares must also be sold and the employee will receive the proceeds. If C Co is listed, the shares are released to the employee.

Result

The taxing point is when the employee leaves, or C Co is sold or listed.

Analysis

Because the employee forfeits the shares for no consideration if they leave, the taxing point will be deferred until the employee leaves (in which case there will be no income), the shares are sold (in which case the sale price will be taxable), or the shares are released to the employee (the market value of the shares will be taxable).

Deduction for employers

Submissions

15. Many submissions supported the proposal to give employers a deduction matching the employee's income. There were also a number who said that deductions for the cost of providing ESS benefits were already available in many situations, and that these should not be disturbed. Examples were:

- deductions taken by employers who are subsidiaries for payments made to their parent in consideration for the issue of ESS shares by the parent;
- deductions for contributions to ESS trusts which are used to acquire shares on market; and
- deductions for bonuses which are used by the employee to pay for the shares.

Response

16. We do not propose any change to the proposal in the issues paper, to give an employer a deduction at the same time and of the same amount as the employee's income. We do, however, want to clarify how that would work, particularly in the situations set out above.

Recharge paid to parent

17. A recharge expense in a subsidiary's financial accounts for an amount paid to a parent for providing a deductible ESS benefit would simply be reversed in the tax calculation, in the same way as (for example) a provision for holiday pay. The issue of shares by the parent would give rise to a deduction for the subsidiary, and to additional ASC for the parent. The subsidiary's available subscribed capital (ASC) would be increased by the amount of the deduction less the recharge (or decreased if this is a negative amount).

Contribution to ESS trust

18. Contributions to an ESS trust would cease to be deductible. Nor would the trust be entitled to a deduction for the cost of acquiring the shares. This is the same treatment as applies when a company acquires its own shares. This clearly does mean that in such a case, the amount for which a deduction is claimed as a result of providing an ESS benefit will not reflect the cost to the company of acquiring the shares. This is entirely appropriate. It is no different from the situation where a company simply issues a share to satisfy its ESS obligations. In that case, there is no cash cost to the company in making the issue, yet it is appropriate for it to receive a deduction, reflecting the dilution of value for the other shareholders.
19. Where a company chooses to acquire shares on market for the purpose of providing them to employees, the company is simply choosing, for administrative reasons, to use pre-existing shares to satisfy its ESS obligations. This process requires the company in effect to reduce its capital (by paying money to the ESS trust which then uses it to acquire the ESS shares from existing shareholders). This capital reduction does not dilute the value of the other shareholders' interest in the company. It is not appropriate to treat this as an expense. Instead it should be treated as reducing the company's ASC.
20. For example, suppose an employer contributes \$5,000 to an ESS trust, which uses the money to acquire 2,500 shares on market at \$2 per share. One hundred of these shares are allocated to an employee, with vesting only if the employee is still employed in one year. One year later, when the shares are worth \$2.20, 100 shares vest. Under the proposals, the initial payment of \$5,000 would not be deductible. But the employer would be entitled to a deduction for \$2,200 when the 100 shares vest.

Bonus used to pay for shares

21. A bonus which is returned to the company to pay for shares could be simply disregarded. However, it seems to be more consistent with existing practice to recognise both the bonus and the contribution to acquire the shares. The bonus will be deductible to the company. The employee will be treated as using the bonus (less PAYE) to pay for the shares. The employee will have total taxable income equal to the bonus plus the difference between the value of the shares at the taxing point and the

bonus after PAYE. If this is a negative amount, the employee will be entitled to a deduction for it, and the employer will have income.

22. For example, suppose shares worth \$3,000 are acquired by an ESS trustee on behalf of an employee, subject to a one year vesting period. The employee is required to pay for these shares when they vest, but is entitled to a grossed-up bonus to fund the repayment. If the employee remains employed for the year, they will receive a bonus of \$4,500, of which \$1,500 is paid in PAYE and \$3,000 used to pay for the shares. Suppose the shares are worth \$2,500 at that time. The employer will be entitled to a deduction of \$4,500 for the bonus, and to a further deduction equal to the value of the shares less the amount received for them. Because that amount is negative ($\$2,500 - \$3,000$), the employer will have income of \$500. The tax outcome is the same as if the employer had simply issued the shares to the employee after the one year vesting period, and paid the employee a further \$1,500. This accurately reflects the commercial reality.

Transitional

23. It is obviously not appropriate for the same amount to be deductible twice. Accordingly, deductions would not be permitted under the proposed rules for providing a share for which a deduction has already been claimed on a recharge or trust contribution approach.

Start-up companies

24. Most submissions did not support special rules for start-up or unlisted companies, and so we do not propose any. We note that within our proposed principles, schemes can be designed which appropriately defer the taxing point until there is (or is very likely to be) either liquidity or no prospect of liquidity. For example:
- an option scheme with a 10-year exercise period; or
 - a share scheme where the benefit of the shares is lost if there is no IPO or sale within 10 years.
25. Of course, the quid pro quo for such deferral is that the employee will not have crystallised a benefit until the taxing point arises.

Widely offered schemes

Submissions

26. There was considerable support in submissions for a continued exemption for benefits provided under widely offered ESS. However, submissions also criticised various restrictive aspects of the current rules, and were in most cases prepared to forego the 10% deemed deduction.

Response

27. On the basis that employers are not entitled to any deduction for the cost of providing the benefit in an exempt scheme, we believe that the fiscal cost of a widely offered scheme exemption may be outweighed by the compliance savings and possible

intangible benefits. Accordingly, we are considering continuing with an amended exemption for widely offered ESS. We are considering an exemption along the following lines, and seek submissions on this.

Availability

28. As at present, made available to all employees equally, subject to prior employment qualification of no more than three years, with a pro rata reduction for part time or seasonal workers.

Vesting period

29. As at present, minimum three-year vesting period. However, if employee leaves employment due to sickness, accident, death, redundancy, retirement at normal age, or if the scheme terminates due to change in ownership of the employer, it is permissible for the employee to receive a pro rata portion of the shares (or equivalent benefit).

Cost of shares to employee

30. The cost of the shares would need to satisfy three requirements.
- no more than \$5,000 pa;
 - no more than \$2,000 less than the market value (so if market value is \$2,000 or less, cost can be zero); and
 - no more than the market value.

Loan requirement

31. If there is a cost to the employee to acquire the shares, the employer must provide an interest-free loan facility, which must be repayable over the vesting period – more flexibility over repayment terms than current legislation may be desirable.

Dividends

32. As at present, paid to employee, not applied against loan.

Deduction to employer/trust

33. No deduction for cost of providing shares, and no deemed 10% deduction.

Commissioner approval

34. Registration rather than approval.

Transitional

35. Existing section DC 12 schemes should meet all of these requirements. Accordingly, there does not seem to be any need for a transitional rule. The existing legislation can be repealed and replaced from the enactment date. The only exception would be to grandfather the 10% deemed interest deduction on loans made before the effective date.

Transition/grandparenting

Issues paper proposal

36. The issues paper proposed grandparenting for benefits where the taxing point under existing law arises before the enactment date of the new law, provided the taxing point for those benefits under the new law arises before the end of the third full tax year following enactment. This proposal reflected a desire not to impose the new rules with inappropriate haste, but also not to allow the new rules to be circumvented.

Submissions

37. Many submitters were happy with this proposal. Others made the point that:
- for schemes with vesting periods of more than three years, this approach means that grants made before enactment date and in the ordinary course would not have grandparenting relief; and
 - applying the new rules from enactment would be problematic, in that employers offering schemes whose tax treatment is affected by the rules need time after enactment to ensure that their schemes work appropriately under the new rules.

Response

38. In response to these submissions, we have amended our proposal for transitional relief as follows. The proposals would not apply to:
- benefits granted before the date six months after enactment in accordance with the terms of any ESS in existence before the release of the issues paper on 12 May 2016; and
 - benefits granted before the date six months after enactment where the taxing point for the benefits under the new law is before 1 April 2022,
- provided that the decision to grant the benefits was made in the ordinary course of business and without a purpose of preventing the application of the new law.

Provisional tax

39. A number of submitters raised the difficulty for employees in complying with the provisional tax regime.
40. We acknowledge that the provisional tax regime is seen as complex by some. However:
- from 1 April 2017 employers can elect to pay PAYE on ESS benefits to ensure employees are not subject to provisional tax;
 - retention of tax exempt schemes will keep many employees receiving ESS benefits out of provisional tax;
 - in the 2016 Budget the Government announced a number of measures to simplify the application and consequences of provisional tax through an increase in the safe harbour and modifications to the standard uplift method which should reduce the impact of provisional tax to those who earn ESS benefits.

41. While it would be possible to exclude ESS benefits from the application of provisional tax there is an equity issue with other types of one-off income which would continue to have provisional tax implications, it would be more appropriate to consider this as part of the continuing business tax stream of Business Transformation. Accordingly, we do not recommend looking at any measures to change the application of provisional tax to ESS benefits at this time.

Consequential

42. A number of submissions asked about the flow-on consequences of our proposals. The issues raised, and our responses, are as follows:

- Do the proposals mean ESS shares will be treated as always being on revenue account?

No, this will depend on application of the existing law.

- Would ESS shares received by an employee be treated as having a cost base if they are on revenue account?

Yes, equal to the income recognised by the employee, excluding any PAYE, plus the amount paid for them, if any. For example, if the ESS shares have a taxable value of \$3,000, and the employer has paid PAYE of \$1,500 with respect to that benefit, the cost base for the employee would be \$3,000.

- Would the issue of shares by a company or trustee under an ESS give rise to ASC for the company?

Yes, there will be ASC for the company equal to the amount of the deduction (less any PAYE).