Regulatory Impact Statement

Taxation of Employee Share Schemes

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to improve the framework for taxing employee share schemes (ESS). In some circumstances, the current tax rules can result in over-taxation; in others they result in under-taxation. The options considered in this Regulatory Impact Statement seek to address these issues.

To analyse the options for taxing ESS, tax policy officials gathered case-based evidence of the range of commercial practices that currently exist. We researched the historic basis of the existing law. We then identified areas where the current law is deficient in light of our broad-base, low-rate taxation framework. Having identified areas where the law is deficient and unclear, we undertook an analysis of the optimal taxation framework for taxing ESS and tested possible solutions against that framework.

In considering various options, we considered quantitative data where it was available. Unfortunately, there are no comprehensive statistics on how widespread employee share schemes are and what form they take. There is also no comprehensive data on the tax treatment of these schemes. So while we know ESS are an important form of remuneration, we cannot be sure of the number of employees participating in different types of schemes or how much remuneration is provided through ESS. Accordingly, officials are also unable to provide quantitative estimates of the costs and benefit of maintaining the status quo.

To address this limitation, in some cases we had to look to Australia for data. We made some adjustments to the Australian data to attempt to more accurately reflect the New Zealand environment.

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STATUS QUO AND PROBLEM DEFINITION

Overview

1. Employee share schemes (ESS) – arrangements providing shares and share options by companies to employees – are an important form of employee remuneration in New Zealand and internationally. Although the commercial design and the accounting treatment of these plans have evolved considerably over recent decades, the tax rules applying to them in New Zealand have not been comprehensively reviewed during that period and are now out of date.

2. ESS can have beneficial economic effects (in terms of aligning employee and shareholder interests, promoting financial literacy and allowing cash poor companies to attract top employees) and it is important that the tax rules do not raise unintended barriers to their use. In some circumstances, the current rules can result in over-taxation; in others they result in under-taxation. There is no comprehensive data to quantify the size of this problem.

Status quo

3. The taxation of ESS is governed by the Income Tax Act 2007 (ITA).

Framework for taxing employee share schemes

4. Broadly speaking, there are two potential frameworks for taxing ESS:

- a **neutral tax framework** consistent with New Zealand's BBLR tax policy settings. Under a neutral tax framework, the tax treatment of employment income paid in shares should be consistent with the taxation of employment income paid in cash. That is, ESS should not be at a tax advantage or disadvantage compared to a cash salary; or
- a **concessionary framework** where ESS are offered tax incentives. ESS are offered to help align incentives of employees with those of the firm and to improve general employee engagement. Given these positive effects, it is sometimes suggested that these schemes should benefit from tax incentives.

5. The current framework for taxing employee share schemes is mixed, and in some cases, unclear. Generally speaking, most ESS are intended to be taxed under a neutral tax framework. However, there are inadvertent tax benefits associated with some schemes that make them more attractive than other types of schemes, or equivalent cash salary (notably the recharacterisation of labour income as tax-free capital income). In addition, the current law contains a deliberate, narrow tax exemption and deemed notional interest deduction for widely-offered schemes.

Treatment of employees' income

6. Employee share schemes may be divided into three general categories:

- *Unconditional ESS* – which provide shares or options to employees free from further conditions.
- *Conditional ESS* – where the shares or options received by employees are subject to future employment conditions.

- *Options and option-like arrangements* – options allow employees to purchase shares in their employer at a predetermined time in the future for a predetermined price ("strike price"). Option-like arrangements are in the form of a share purchase, but have terms and conditions (often based on the price of the shares) and other features that make the arrangement similar in economic effect to an option. Option-like arrangements often have employment conditions in addition to the price conditions.

7. **Unconditional and conditional ESS** are currently taxed as follows. Employees are taxed when they acquire the shares. In the case of a conditional scheme, the shares are commonly given to a trustee to hold until the condition is met. This is treated as acquisition by the employee. The taxable income is the difference between the value of the shares at that time and the price they pay for them. If employees pay full market value for the shares, then no taxable income arises. At the other extreme, if employees are given shares for no consideration, then the full market value of the shares is taxable income.

8. With **share options**, employees are given a right to purchase shares at some future date for a set price (the strike price). This right itself may be subject to the satisfaction of a future condition. In that case, the options are often referred to as "vesting" when the condition is met. An employee will exercise the option if the shares' value at the future date exceeds the strike price – the option effectively allows them to acquire the shares at a discount. If the strike price exceeds the shares' value the employee will not exercise their option. When an employee receives an option, employment income equal to the value of the option is received and that income should be subject to tax.

9. Under current rules, no tax is paid when the option is issued or vests. An employee participating in a share option plan is taxed only if and when the option is exercised. The difference between the market value of the shares at exercise and the strike price is taxable income. This approach is *tax at exercise*.

10. A number of employee share schemes make use of interest-free loans. Interest-free loans provided to employees by their employer are generally subject to FBT. However, FBT is not payable in respect of an interest-free loan provided by an employer to enable an employee to purchase the employer's shares, provided certain criteria are satisfied. The FBT exemption is appropriate because it ensures the tax treatment of the interest-free loan is the same as if the employer had charged interest, but paid the employee extra salary to meet the interest cost.

Treatment of employers

11. Under current law there is no explicit deduction for a company that provides shares to an employee at a discount. However, there are structures that can be adopted by employers to achieve a deduction. While we do not have comprehensive data on the use of these structures, we understand they are very widespread.

Widely-offered schemes

12. The ITA currently provides a concessionary regime to encourage employers to offer shares to employees under certain widely-offered employee share schemes.

13. There are two main tax benefits available under the concessionary regime:

- **Exemption for employee**: The value of a benefit received by an employee under a concessionary scheme is not taxable to the employee.

- **Deemed interest deduction for employer**: The employer company is given a deemed deduction of 10% notional interest on loans made to employees to buy shares. This is additional to any deduction for actual interest incurred on money borrowed to finance the scheme. There is not intended to be any deduction for the cost of acquiring shares, although we understand in practice many companies have structures in place to achieve unintended deductions.

14. Another benefit under the concessionary regime is that interest-free loans made under a qualifying employee share scheme are automatically exempt from fringe benefit tax (FBT).[1]

Start-up companies

15. There are currently no special rules for ESS offered by start-up companies, although they face particular practical barriers to offering ESS.

16. As stated above, they may have difficulties valuing employee share scheme benefits. They also may not have sufficient cash at the employee and employer level to fund tax imposed on the grant or vesting of shares, or the exercise of options.

17. While similar problems can exist for any unlisted companies, more mature companies can generally put in place mechanisms to deal with them. Start-ups are especially affected by these problems because they lack the cash to pay the tax on behalf of employees and their shares are very difficult to value using orthodox methodologies.

Reporting and administrative requirements

18. There are currently no specific reporting requirements for employers offering, or employees participating in, employee share schemes. While employers offering the tax-exempt schemes discussed above must apply to the Commissioner of Inland Revenue initially for approval, there are no on-going reporting requirements with respect to these schemes.

19. From 1 April 2017, employers will be required to include employees' ESS benefits in the employer monthly schedule (EMS) (whether they elect to withhold PAYE or not). However, this amendment does not require the employer to provide specific details of the share scheme benefits provided.

20. The current lack of reporting raises a number of issues:

- it is difficult to know whether employers and employees understand and are complying with their share scheme tax obligations;
- employees may not have sufficient information to complete their tax return; and
- there are no comprehensive statistics on how widespread employee share schemes are and what form they take.

[1] The majority of employee share scheme loans are exempt from FBT.

Other government interventions/programmes

21. The New Zealand Government is committed to removing barriers to offering these schemes – especially for start-ups. Recent changes to the Financial Markets Conduct Act 2013 exempt many ESS from the requirement to offer a prospectus to employees. This was seen as a major simplification measure and was welcomed by the business community. In the course of our consultation it was mentioned as a step which was likely to increase the use of ESS.

Problem definition

22. As discussed above, in some circumstances the status quo results in over-taxation and, in others, under-taxation. There are also significant administrative and compliance costs associated with the status quo. There is no comprehensive data to quantify the size of this problem.

Current impediments and potential over-taxation

23. The current system impedes the use of ESS in a number of ways. These problems can be particularly relevant for start-up companies.

- There is considerable uncertainty about how the current tax rules apply to employees and employers, which may deter firms from offering these schemes.
- The costs to employers of providing shares to employees are not explicitly deductible. Non-deductibility creates a disincentive to using employee share schemes.
- Unlisted, and in particular start-up, companies may have difficulties valuing employee share scheme benefits.
- Start-up companies may not have sufficient cash-flow at the employee and employer level to fund tax payments triggered by the vesting or receipt of illiquid shares.

Potential under-taxation

24. The current treatment of some sophisticated employee share schemes can result in taxable employment income being treated as tax-free capital gains and so escaping taxation. This undermines the fairness of the tax system. These sophisticated employee share schemes can provide a significant amount of untaxed employment income for some high income earners.

Root causes of these problems

25. The root causes of these problems are:

- that New Zealand does not tax capital gains, but does tax labour income. This creates incentives and opportunities for people to recharacterise labour income as tax-free capital gains. These transactions are possible where tax rules are unclear or contain loopholes;

- the tax law relating to ESS is out of date, ambiguous and has not kept up with commercial developments – the legislation was enacted in the late 1960s and early 1970s and has not been comprehensively reviewed since then. Therefore, there is scope for employers/employees to avoid tax on what is essentially remuneration for services.

Quantifying the costs and benefits of the status quo

26. Employee share schemes are fairly widespread in New Zealand businesses. Large listed companies use them, as do start-up companies and medium sized privately-held companies. There are different types of schemes: high value schemes offered to a small group of senior executives, moderate value schemes offered to a wider range of managers and low value schemes offered to all employees. Some companies offer more than one type of scheme.

27. However, there is no comprehensive data on employee share schemes in New Zealand. KPMG has recently published a survey of NZX listed companies suggesting that 78% of NZX 50 Index companies offer at least one employee share scheme.[2] The New Zealand Venture Investment Fund (NZVIF) also published a report into the use of employee share schemes by New Zealand start-up companies. Of the 50 companies that responded to their survey, 88% currently have a specific provision in their shareholders' agreement/constitution allowing them to offer employee share schemes.[3]

28. So officials know ESS are an important form of remuneration, but cannot be sure of the number of employees participating in different types of schemes or how much remuneration is provided through ESS. Accordingly, officials are also unable to provide quantitative estimates of the costs and benefit of maintaining the status quo.

29. The table below lists the costs and benefits of the status quo based on anecdotal evidence.

Costs of status quo	Benefits of status quo
Lack of legislative certainty increases compliance and administrative costs. Examples of legislative uncertainty include: whether the law currently requires a widely-offered scheme to have a loan and what the "acquisition" point is for shares.	Rules have been in place for 40 years so companies have bedded in ESS arrangements. Maintaining the status quo avoids companies and Inland Revenue having to incur the costs associated with changing schemes and systems.
Efficiency costs as employers structure arrangements to provide tax-free capital gains instead of providing taxable labour income – this may result in an inefficiently high amount of ESS income.	Some private sector advisors and companies argue being able to access capital gains tax-free adds to incentive effects and allows companies to more easily attract skilled workers.
Unnecessary transaction costs to implement complicated tax-driven structures to achieve tax-free gain/a deduction for the employer when one would not otherwise be available.	
Equity costs – people who are able to participate in ESS and obtain tax-free capital gains are advantaged versus those who can only earn taxable salary and wages.	
There is a cost to Government revenue as some labour income currently goes untaxed (this is mitigated to some extent by the lack of deduction at the employer level).	

[2] https://assets.kpmg.com/content/dam/kpmg/pdf/2016/02/NZ-Employee-Share-Schemes-Brochure-Feb-2016.pdf

[3] http://www.nzvif.co.nz/assets/publications/ESOP-Survey-Report.pdf

OBJECTIVES

30. The **main objective** of this reform is to modernise and improve the taxation of ESS so it is simple, efficient and fair.

31. All options are assessed against the status quo in relation to the main objective and the following **five criteria**:

- **Neutrality** – this means that the imposition of tax should not affect the form in which employees are paid. Tax neutrality is a core part of New Zealand's general BBLR approach to taxation. Tax neutral treatment of the employment income means, as much as possible, we should tax all types of employee remuneration, whether paid in cash or shares or other assets, consistently; and ensure that taxation does not distort remuneration decisions. This ensures employees are remunerated in the most economically efficient (rather than the most tax efficient) form. An alternative approach would be to provide tax concessions for employee share schemes. In our view, is only appropriate to consider tax concessions if there are positive externalities associated with an activity – that is positive benefits to wider society, not just benefits captured by the parties to the arrangements. Because there is no evidence that ESS provide positive externalities the best tax policy framework for ESS is one that is neutral.

- **Equity** – to support fairness in the tax system, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way. In particular:
    i. employees paid in shares should not have a tax advantage compared to employees receiving cash salary and wages; and
    ii. employers paying employees in shares should not be disadvantaged compared to employers paying cash.

- **Compliance costs** – compliance costs to businesses and employees should be minimised as much as possible.

- **Administrative costs** – administrative costs for Inland Revenue should be minimised as much as possible.

- **Integrity** – options should safeguard the tax system against tax avoidance and evasion. The options should also contribute to a coherent set of rules for taxing labour income.

Constraints

32. We were also constrained in terms of the administrative options we were able to consider because of Inland Revenue's current Business Transformation programme.

Trade-offs

33. There are trade-offs between the various criteria.

34. In particular, there is a trade-off between minimising administrative and compliance costs, and increasing the integrity and equity of the system. In the case of executive level schemes, more weight is placed on increasing equity and integrity than minimising compliance costs. This is because there are often high levels of remuneration being provided through these schemes and compliance costs are relatively smaller as a proportion of the remuneration being provided. This high level of benefit also makes integrity and equity relatively more important.

35. In the case of the widely-offered schemes, there is a trade-off between neutrality and minimising compliance costs (see table 3 below). In these schemes compliance costs had a higher weighting than neutrality because of the low level of benefits that are able to be provided through the schemes and the feedback we received from submitters as to how increased compliance costs would affect them. Potential compliance costs for these schemes are high as a relative proportion of benefits provided through the scheme. In some cases submitters indicated the compliance costs associated with removing the tax exemption and requiring employers to return these amounts on the employer monthly schedule would outweigh the amount of benefit provided, meaning the schemes would no longer be viable.

REGULATORY IMPACT ANALYSIS

36. There are three areas of reform covered in this regulatory impact analysis:

1. Taxing employees' income
2. Allowing deductions for employers' costs
3. Tax exemption for widely-offered schemes

37. Within each of these areas, the practical options for reform that may wholly or partly achieve the main objective are exclusively regulatory.

38. In the following paragraphs, we outline the options for reform we considered. Each topic has a corresponding table where we analyse each option by reference to the **five criteria** we identified in paragraph 31 and the **main objective** in paragraph 30.

39. Within the tables, the following symbols are used to assess each option against the status quo:

✓✓ Significantly better than the status quo
✓ Better than the status quo
× No better than the status quo
×× Worse than the status quo

40. None of the options identified in any of the areas have social, environmental or cultural implications.

Taxing employees' income

41. The options we considered are as follows:

1. **Option A – status quo**: this option is summarised in paragraphs 6 to 10. Essentially shares are taxed when they are acquired by an employee (or trust), even if they have not yet been earned or they are subject to an arrangement that protects employees from suffering an economic loss if the share price declines. Options are taxed on exercise. In both cases, the assessable income is the market value of the shares at the time they are acquired (including through the exercise of an option), less any amount paid for them.

2. **Option B – tax employee on grant:** this would involve taxing an employee on the value of the arrangement when they enter into it. For example, when an option is granted to an employee or when an employee is promised shares under an ESS if they perform services for a certain period of time.
3. **Option C – tax employee when the shares vest:** this involves taxing employees when they have done everything they have to do to earn the shares and they hold them on (essentially) the same basis as other shareholders (including not having any protection from suffering an economic loss if the share price declines). Under this option, employees are taxable on the market value of the shares at the time they vest, less any amount they pay for the shares. Consistent with existing law, options would be taxed when they are exercised (even if the options themselves have vested at an earlier date). The assessable income would be the market value of the shares at the time they are acquired through the exercise of the option, less any amount paid for them.

4. **Option C2 – same as Option C above, but tax options when they *vest*, not when they are *exercised*.** An option vests when an employee has done everything they have to do to earn it and it can no longer be forfeited. An option may vest some time before it is (or is able to be) exercised. Under this option, the assessable income would be equal to the value of the option on the date it vests, estimated using an option valuation model (such as the Black-Scholes-Merton model), rather than when the option is exercised on the value of the shares at that time less any amount paid for them.

5. **Option D – tax employee when they sell the shares**: tax could be imposed on shares at the time they are sold. The assessable income would be equal to the proceeds of sale less any amount the employees paid to acquire the shares. This means employees will have the cash to pay the tax and the market value will be more easily established.

Table 1 - Taxing employees' income

	Neutrality	Equity	Minimises compliance costs	Minimises administrative costs	Integrity	Assessment against main objective	Fiscal impact
Option A – status quo	ESS benefits taxed differently from cash salary and other in-kind benefits. Taxation of shares at grant is not consistent with taxation of options on exercise.	ESS benefits are often tax advantaged.	Significant compliance costs associated with uncertainty of the law. Valuation and cashflow issues also cause significant compliance costs – especially for start-up companies.	Significant administrative costs associated with uncertainty of the law	Many opportunities for tax avoidance and evasion. The law is not coherent	*Does not meet the main objective*	Not applicable
Option B – tax on grant	**××Worse than the status quo** ESS benefits taxed differently from cash salary and other in-kind benefits.	**×No better than status quo** ESS benefits taxed differently from cash salary and other in-kind benefits.	**××Worse than the status quo** Significant compliance costs involved in valuing the "promise" to pay in the future.	**××Worse than the status quo** Significant administrative costs involved in valuing the "promise" to pay in the future.	**×No better than status quo** Does not address all opportunities for tax avoidance and evasion. Taxation of employment income is not coherent	*Does not meet the main objective*	Unable to estimate
Option C – tax on shares vesting (and options on exercise)	**✓✓Significantly better than the status quo** ESS benefits taxed the same as cash salary and other in-kind benefits. In some cases the shares cannot be realised to pay tax. There are ways to address this.	**✓✓Significantly better than the status quo** ESS benefits taxed the same as cash salary and other in-kind benefits. However, in some cases the shares cannot be realised to pay tax. There are ways to address this.	**✓Better than the status quo** The law will be clearer and more certain, which reduces compliance costs. Valuation issues and tracking vesting may increase compliance costs for some segments of the market. These costs will largely fall on businesses. We do not expect start-up companies to face significantly higher compliance costs as a result of this option.	**✓Better than the status quo** The law will be clearer and more certain, which reduces administrative costs. However, auditing valuation and vesting may increase administrative costs.	**✓✓Significantly better than the status quo** Addresses avoidance concerns and makes the taxation of employment income more coherent.	*Meets the main objective* **Preferred option**	Likely to increase revenue compared to status quo
Option C2 – tax options on vesting	**✓Better than the status quo** As for Option C, but taxing options on vesting exacerbates this cash-flow problem.	**✓Better than the status quo** As for Option C, but taxing options on vesting exacerbates this cash-flow problem.	**✓Better than the status quo** As for Option C, but valuing options is difficult and unreliable in this context. Extra compliance costs involved in valuing option correctly.	**✓Better than the status quo** As for Option C, but valuing options is difficult and unreliable in this context. Extra administrative costs involved in testing valuations.	**✓✓Significantly better than the status quo** Addresses avoidance concerns and makes the taxation of employment income more coherent.	*Partially meets the main objective*	Likely to increase revenue compared to status quo
Option D – tax on sale	**××Worse than the status quo** ESS benefits taxed differently from other in-kind benefits.	**××Worse than the status quo** ESS benefits taxed differently from other in-kind benefits. However, it is more equitable in that it only taxes employees when they have the cash to pay the tax. It is also easier to establish the value of the shares.	**×No better than status quo** There will be some extra compliance costs in tracking sale of shares, but the real benefit of this option is that it reduces compliance costs involved in arranging for cash to pay the tax and getting valuations.	**××Worse than the status quo** The administrative costs in tracking and auditing ESS will increase under this option	**××Worse than the status quo** Deferral opens up opportunities for evasion	*Does not meet the main objective*	Unable to estimate

Allowing deductions for employers' costs

42. The options we considered are as follows:

1. **Option A – status quo**: no specific statutory deduction, but employers generally structure their ESS to achieve a deduction. Deductions are generally achieved by the employer (a) paying employees a deductible bonus which is used to buy the shares (or repay a loan used to buy the shares); (b) making a payment to an ESS trust which is used to buy shares for the employees; or (c) making a "recharge" payment to a parent company to procure the parent company to provide shares to the subsidiary company's employees. Deductions are for the actual cash costs incurred and are generally deductible when paid (although in some cases the payment may be spread over the term of the ESS or deductible on a deferred basis).

2. **Option B – matching deduction:** employers would be entitled to a statutory deduction equal in timing and quantum to the employees' income.

3. **Option C – following International Financial Reporting Standards (IFRS)**: IFRS requires companies to recognise an expense association with the provision of options or shares under an ESS. The expense is generally calculated at the date of grant and spread over the term of the ESS.

Table 2 - Allowing deductions for employers' costs

	Neutrality	Equity	Minimises compliance costs	Minimises administrative costs	Integrity	Assessment against main objective	Fiscal impact
Option A – status quo	The provision of ESS benefits may be non-deductible. If they are deductible, the deduction does not generally match the employees' income. This is inconsistent with the way the cost of cash salary and wages are treated.	The lack of statutory deduction for ESS benefits means employers are disadvantaged vis-à-vis paying cash salary. To achieve deductions they have to incur costs to structure around this issue.	Significant transaction and compliance costs associated with structuring to achieve deductibility. There is also uncertainty in the law which results in high compliance costs. Borne by employers.	Administrative costs associated with uncertainty of the law.	Some opportunities to potentially accelerate deductions. The law relating to employment income is not coherent	*Does not meet the main objective*	Not applicable
Option B – matching deduction	**✓✓Significantly better than the status quo** ESS benefits taxed the same as cash salary and wages for both employer and employee, and taxed consistently between themselves.	**✓✓Significantly better than the status quo** ESS benefits taxed the same as cash salary and wages.	**×No better than status quo** Reduced compliance costs associated with structuring, but will need to value shares when they vest to determine deduction. Some companies report that there will be increased compliance costs associated with accounting for the tax effect of the new regime under IFRS. This issue seems to be confined to certain types of structures and certain taxpayers. Costs borne by employers.	**✓Better than the status quo** Reduced administrative costs because law is more certain. Potentially increased administrative costs as more companies having to value shares.	**✓✓Significantly better than the status quo** Removes opportunities for tax avoidance and evasion, more coherent and clear law relating to employment income	*Meets the main objective* **Preferred option**	Likely to slightly reduce revenue
Option C – follow IFRS	**××Worse than the status quo** ESS benefits taxed differently from cash salary and wages. Other deductions do not follow IFRS.	**××Worse than the status quo** ESS benefits would potentially be tax advantaged or disadvantaged.	**××Worse than the status quo** Many companies do not use IFRS, so they may need to use them just for ESS benefits. IFRS rules are complex and require the use of option pricing models. For some large taxpayers who use IFRS already, there would be reduced compliance costs.	**××Worse than the status quo** Increased administrative costs associated with monitoring IFRS compliance.	**××Worse than the status quo** Potential for avoidance and abuse (IFRS allows a wide range of values). Rules around employment remuneration not coherent.	*Does not meet the main objective*	Likely to significantly reduce revenue

Tax concessions for widely-offered schemes

43. The options we considered are as follows:

1. **Option A – status quo**: complex legislation allowing shares to be provided tax-free to employees so long as they pay no more than $2,340 to buy them over a three year period and all employees are entitled to participate on an equal basis. A number of other criteria must be met. Employers are entitled to a deemed deduction equal to 10% of any loans provided to employees to purchase shares under a qualifying scheme. Currently employers are able to claim unintended deductions for amounts contributed to trusts to purchase shares.

2. **Option B – repeal tax concessions for widely-offered schemes:** remove tax exempt schemes – all employee share schemes treated the same for tax purposes.

3. **Option C – retain and modernise widely-offered schemes**: as well as improving some of the ambiguous drafting, the current limit on the amounts employees can pay for their shares could be increased to take account of inflation since the threshold was last increased. In addition:

    a. the scheme could be relaxed so it only has to be offered to 90% of employees (rather than 100%);
    b. an upper limit would need to be placed on the exempt benefit to employees;
    c. the deemed interest deduction should be removed;
    d. it should be made clear that any deduction for the cost of providing shares under the scheme is to be denied;
    e. the legislation could clearly state that a loan is only mandatory to the extent that employees have to pay something for the shares; and
    f. the requirement for the scheme to be "approved" by the Commissioner of Inland Revenue (CIR) should be replaced by a registration requirement.

Table 3 – Tax concessions for widely-offered schemes

	Neutrality	Equity	Minimises compliance costs	Minimises administrative costs	Integrity	Assessment against main objective	Fiscal impact
Option A – status quo	ESS benefits are exempt from tax, whereas comparable salary is not. Deemed 10% interest deduction and deduction for contribution to trust also different to treatment of standard salary and other types of ESS.	ESS benefits are tax advantaged.	Significant transaction and compliance costs associated with setting up schemes. There is also uncertainty in the law which results in high compliance costs. Borne by employers.	Administrative costs associated with uncertainty of the law.	Some avoidance opportunities. Does not fit with BBLR system.	*Does not meet the main objective*	Not applicable
Option B – repeal tax concessions for widely-offered schemes	✓ **Better than the status quo** ESS benefits taxed the same as cash salary and wages for both employer and employee, and taxed consistently between themselves. However, ESS incurs significantly more compliance costs for low level of benefit.	✓ **Better than the status quo** ESS benefits taxed the same as cash salary and wages. However disadvantaged as compared to salary and wages that do not incur compliance costs.	**××Worse than the status quo** Significant transaction and compliance costs associated with bringing tax-exempt schemes into the tax system. In many cases these costs likely to outweigh the benefits offered under the scheme.	**××Worse than the status quo** Reduced administrative costs because law is more certain. However, potentially more resources needed to monitor previously tax-exempt schemes.	**✓✓Significantly better than the status quo** Removes opportunities for tax avoidance and evasion. Coherent and clear law relating to employment income	*Meets the main objective*	Broadly fiscally neutral
Option C – retain and modernise widely-offered scheme	**×No worse than the status quo** ESS benefits are exempt from tax, whereas comparable salary is not. Denial of deduction also different to treatment of standard salary and other types of ESS – however this is a necessary corollary of the tax-exemption.	**×No worse than the status quo** ESS benefits are tax advantaged. However, compliance cost barrier is removed.	**✓✓Significantly better than the status quo** Significantly reduces compliance costs.	**✓✓Significantly better than the status quo** Reduces administrative costs.	**✓Better than the status quo** Loopholes removed, but differential treatment does not fit with BBLR framework.	*Meets the main objective* **Preferred option – on balance compliance costs are a major consideration**	Broadly fiscally neutral

CONSULTATION

44. Consultation is an important part of the Generic Tax Policy Process (GTPP). Tax policy officials undertook numerous discussions with stakeholders before releasing an issues paper for formal public consultation. Submitters had six weeks to submit on the issues paper. Twenty seven submissions were received. Thirteen were from corporates, seven were from industry bodies and seven were from professional services firms. After submissions were received, officials met with a number of submitters to discuss their submissions. As a result of submissions, it became apparent there were specific issues that would benefit from further consultation. Officials released a subsequent consultation letter and allowed a further four weeks for submissions. During this time, officials again met with a number of submitters to help inform their further submissions. Eighteen further submissions were received. Six were from corporates, three were from industry bodies and nine were from professional services firms. The analysis of options to improve the framework for taxing ESS was significantly informed by submissions received.

45. As an overall observation, submitters were not generally in favour of the proposals to change the tax treatment of ESS benefits in the hands of employees. This is to be expected. Some submitters have argued that the reforms tax capital gains. While ESS benefits might sometimes look like capital gains because employees are being paid in shares, the reality is that this is just another form of employment income and should be taxed as such. The proposals isolate employment income and tax that. They ensure that all employment income is treated the same and will reduce opportunities to substitute non-taxable gains for taxable salary. The proposals do not prevent employees from ever being able to hold their shares on capital account and receive gains tax-free. They simply ensure that employees are taxed on the value of the shares they receive when those shares are payment in-kind for services. Once the employee owns the shares like any other investor they can derive tax-free capital gains.

46. Some submitters also advocated for a concessionary framework, rather than the neutral tax framework described above. For the reasons already explained, we did not support a concessionary framework.

47. Submitters were generally in favour of providing a statutory deduction for providing ESS benefits, but some disagreed with the proposed basis for those deductions.

48. As a result of consultation, officials made a number of changes to the proposals including:

a. recommending retaining and modernising the widely-offered tax exempt schemes – based on concerns about compliance costs;
b. clarifying when the new rules will and will not apply to common commercial structures – based on some confusion about the border between holding shares as an employee and holding them just like any other shareholder; and
c. extending the transitional/grandparenting arrangements – to address concerns that the proposed transitional arrangements were not long enough for companies to implement new arrangements and to take account of longer terms schemes.

49. Based on feedback from submitters, we have also recommended considering a second stage of ESS reforms to consider whether it is feasible and desirable to design a start-up deferral regime which would address issues of cash flow and liquidity for early stage companies.

50. Tax policy officials consulted with other government agencies – specifically The Treasury, a number of units within the Ministry of Business, Innovation and Employment (MBIE) and Callaghan Innovation.

51. Tax policy officials also contacted officials in Australia, the United Kingdom and South Africa to gain insights into the way they tax ESS. This has provided us with some useful guidance in terms of areas where New Zealand's rules are consistent with the treatment in those jurisdictions and where we recommend deliberately departing from the approach in other jurisdictions for some reason – for example, because our tax policy settings are different (for example, we do not have a comprehensive capital gains tax) or because there are particular aspects of the laws of these jurisdictions that officials report are problematic.

CONCLUSIONS AND RECOMMENDATIONS

52. Based on the analysis above, the table below summarises the conclusions of the regulatory impact analysis.

Area of reform	Options	Analysis against the objective and criteria
Taxing employees' income	**Option A** – status quo	***Does not meet the main objective***
	Option B – tax employee on grant	***Does not meet the main objective*** Neutrality ×× Equity × Compliance costs ×× Administrative costs ×× Integrity ×
	Option C – tax employee when the shares vest **Preferred option**	***Meets the main objective*** Neutrality ✓✓ Equity ✓✓ Compliance costs ✓ Administrative costs ✓ Integrity ✓✓
	Option C2 – same as Option C above, but tax options when they *vest*, not when they are *exercised*	***Partially meets the main objective*** Neutrality ✓ Equity ✓ Compliance costs ✓ Administrative costs ✓ Integrity ✓✓
	Option D – tax employee when they sell the shares	***Partially meets the main objective*** Neutrality ×× Equity ×× Compliance costs × Administrative costs ×× Integrity ××
Allowing deductions for employers' costs	**Option A** – Status quo	***Does not meet the main objective***
	Option B – Matching deduction **Preferred option**	***Meets the main objective*** Neutrality ✓✓ Equity ✓✓ Compliance costs × Administrative costs ✓ Integrity ✓✓
	Option C – following IFRS	***Does not meet the main objective*** Neutrality ×× Equity ×× Compliance costs ×× Administrative costs × Integrity ××

Tax concession for widely-offered schemes	**Option A** – status quo	***Does not meet the main objective***
	Option B – repeal tax concessions for widely-offered schemes	***Meets the main objective*** Neutrality ✓ Equity ✓ Compliance costs ×× Administrative costs ×× Integrity ✓✓
	Option C – retain and modernise widely-offered schemes **Preferred option**	***Meets the main objective*** Neutrality × Equity × Compliance costs ✓✓ Administrative costs ✓✓ Integrity ✓

53. In summary, the proposed package involves aligning the taxing point of ESS with when the employee has earned the shares and generally holds them like other shareholders, allowing employers a matching deduction and modernising the widely-offered tax-exempt schemes.

54. It is difficult to quantify the direction or size of the fiscal impacts from this combined package relative to baseline estimates since there is no New Zealand data on the amount of income from ESS. However, on balance the proposals are expected to raise revenue of $30 million per annum once fully phased in.

IMPLEMENTATION

55. The preferred options will primarily require changes to the ITA.

56. Officials recommend any legislative changes be included in the taxation bill scheduled for introduction in early 2017 and should generally apply, unless otherwise stated, from enactment.

57. Transitional rules are very important to ensuring the reforms are fair and give companies and employees an opportunity to update their schemes. However, there is also a need to prevent opportunities for tax structuring. We consulted extensively on transitional rules as part of the consultation on the policy proposals.

58. In broad terms, the transitional rules proposed give companies six months post-enactment where the old law still applies, so they can update their schemes with the benefit of looking at finalised legislation.

59. Specifically, for ESS benefits issued in the ordinary course, there will be:

a. open-ended grandparenting for ESS existing before the issues paper was released in May 2016 if there is a taxing point under the existing law (the "old taxing point") before the 6 month period ends; and
b. grandparenting for other schemes where the old taxing point falls within that 6 month period and the new taxing point occurs before a sunset date of 1 April 2022.

60. The transitional rules have been designed to minimise compliance costs for businesses and employees in moving to the new rules.

61. Otherwise the new rules should apply from the date of enactment.

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

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

64. Inland Revenue has completed an impact assessment of the policy proposal and is confident that it has the capacity to provide the administrative measures necessary to implement these reforms.

MONITORING, EVALUATION AND REVIEW

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

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

67. Because there is no quantitative data on the use of ESS to provide remuneration, it will not be possible to judge the effect of the proposals either on the amount of ESS benefits provided in the economy or on the amount of tax collected on ESS benefits.