Taxation of employee share schemes

An officials’ issues paper

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Prepared by Policy and Strategy, Inland Revenue, and the Treasury
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CHAPTER 1

Summary

1.1 Employee share schemes – arrangements providing shares and share options by companies to employees¹ – are an important form of employee remuneration in New Zealand and internationally. Although the 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the tax rules applying to them in New Zealand have not been comprehensively reviewed during that period and are now out of date.

1.2 Employee share schemes can have beneficial economic effects 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.

Current impediments and potential over-taxation

1.3 The current system impedes the use of employee share schemes in a number of ways. These problems can be particularly relevant for start-up companies.

- There is considerable uncertainty about how the current rules apply to taxation of 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 overtaxation, which is a disincentive to using employee share schemes.
- Start-up companies may have difficulties valuing employee share scheme benefits.
- Start-up companies may not have sufficient cashflow at the employee and employer level to fund upfront tax payments.

Potential under-taxation

1.4 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.

¹ For the purposes of the employee share scheme rules, the term “employee” also includes directors.
A framework for taxing employee share schemes

1.5 The paper sets out a number of proposals to address these problems in a manner consistent with New Zealand’s broad-base, low-rate (BBLR) taxation principles. The goal of the proposals is to ensure that the taxation of employee share schemes is simple, efficient and fair.

1.6 The framework adopted in this document for taxing employee share schemes may be simply expressed. The tax treatment of employment income paid in shares should be consistent with the taxation of employment income paid in cash.

Deductibility of employee share scheme benefits

1.7 The paper notes that, under current law, the cost to employers of providing shares to employees is not explicitly deductible. On the other hand, employment remuneration paid in cash would give rise to deductions. To achieve consistent treatment, the paper proposes giving the employer a deduction equal to the amount of income taxable to the employee.

Types of employee share schemes

1.8 For purposes of exposition, it is useful to distinguish three types of employee share scheme.

Unconditional employee share schemes

1.9 Unconditional employee share schemes are shares and options that are provided to employees free from further conditions. As such, they may be considered to be remuneration for past work.

Conditional employee share schemes

1.10 Conditional employee share schemes involve acquisition of shares by the employee where the retention of the shares is subject to future conditions based on continuing employment.

1.11 Conditional employee share schemes are economically similar to employment-conditional bonuses (i.e. payments in cash). As they have a requirement of continuing employment they can be considered, at least in part, to be a reward for future work. Currently some such schemes are taxed prior to the fulfillment of the employment conditions, which is inconsistent with the taxation of conditional bonuses. Conditional bonuses that depend on future employment services are appropriately taxed when the conditions are fulfilled and the employee receives the bonus. Conditional employee share schemes should be taxed in the same manner.
Option-like arrangements

1.12 Option-like arrangements have terms and conditions based on the future price of the shares or similar criteria and other more sophisticated features. In practice, price conditions are often combined with employment conditions. Under current rules, they are taxed when the shares are first acquired, rather than when the conditions are satisfied and the employee is entitled to keep the shares. The arrangement allows employment income to be converted into tax-free capital gains, so that less tax is paid than for comparable bonuses or unconditional employee share schemes (in particular, employee share options). Those receiving benefits under these schemes in effect pay lower rates of tax on their income than salary and wage earners with similar amounts of income.

Proposed taxation of income of employee share schemes

1.13 No changes are proposed for taxing employment income arising from unconditional employee share schemes. They give rise to employment income when shares are acquired and are appropriately taxed in the hands of the employee under current law. In the case of employee share purchases, this is at the time that shares are provided. In the case of employee share options, this is when the options are exercised. This results in the same after-tax outcomes for the employee as levying tax when options are issued, but avoids many of the valuation and cashflow concerns of tax at issue.

1.14 The paper proposes that income arising from the receipt of shares from an employee share scheme should be calculated and subject to tax only once the employee holds the shares free from substantive conditions. In other words, when the shares are held on the same basis as any other shareholder. This timing would be consistent with the taxation of conditional bonuses and ensures that employment income is appropriately taxed.

1.15 The proposed new rules are intended to resolve current uncertainty in the taxation of share schemes by giving clearer guidance to taxpayers and administrators. They do this by more clearly delineating the timing and amount of employment income to be taxed, and giving an explicit deduction for employer costs related to employee share schemes.

Start-up companies

1.16 The paper recognises that some start-up companies may have particular difficulty valuing shares provided under employee shares schemes and paying tax at the time they are taxed currently. These problems could be avoided by delaying the taxing point until the shares are sold or listed. In some cases, deferred taxation would leave employees in the same after-tax position as if the shares had been taxed when they were provided. However in other circumstances, delay could result in some increase or decrease in taxation. The paper outlines some technical and administrative options for reducing barriers to the use of employee share schemes by start-up companies, and invites comments and suggestions.
Specific concessionary regime for widely offered share schemes

1.17 The paper discusses the existing specific concessionary regime for widely offered schemes. The regime was introduced in the mid-70s and has numerous technical deficiencies. The current proposals, especially the deductibility of issuance costs to the employer, and the proposed amendments to allow employers to pay PAYE on employee share scheme benefits, should facilitate broad-based employee share schemes. In these circumstances, the paper invites comments on whether the concessionary regime should be retained.

Transition

1.18 A transitional period is proposed to allow firms time to adjust to the new rules.

Consultation

1.19 This issues paper has been released under the generic tax policy process (GTPP) to facilitate consultation on this complex area.

How to make a submission

1.20 Officials invite submissions on the suggested changes and points raised in this issues paper. Submissions should be sent to policy.webmaster@ird.govt.nz with “Taxation of employee share schemes” in the subject line.

1.21 Alternatively, submissions can be addressed to:

Taxation of employee share schemes
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

The closing date for submissions is 22 June 2016.

1.22 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.

2 Contained in the Taxation (Transformation: First Phase Simplification and Other Measures) Bill.
Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.
CHAPTER 2

Framework for taxation of employee share schemes

2.1 Under employee share schemes, an employer provides its shares, or options to acquire shares, to employees. Income can result when the price charged to employees for the shares or options is less than their market price. Employee share schemes can align the incentives of employees with those of the firm and its non-employee shareholders and can engender greater work effort and employee engagement.

2.2 It is important that, as far as possible, tax rules are not an obstacle to firms using employee share schemes where they are a sensible and economically efficient form of remuneration.

BBLR and tax neutrality

2.3 The framework adopted to achieve this result is one of tax 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.

2.4 Tax-neutral treatment of the employment income in employee share schemes means, as much as possible, we should tax all types of employee remuneration, whether paid in cash or shares, consistently. It also means we should ensure that taxation does not act as an impediment to otherwise sensible remuneration decisions.

2.5 Under the BBLR framework, tax bases are defined as broadly as possible, so no activity or form of payment (such as remuneration in shares) is either advantaged or disadvantaged through the operation of the tax system. This helps reduce economic distortions. It also helps keep tax rates low as a broader base means the Government’s revenue needs can be met with lower tax rates. This, in turn, also helps reduce the distortions generated by the tax system.

2.6 A BBLR tax system also ensures that taxes are fair because, as much as possible, all forms of income are subject to tax. New Zealand’s personal income tax rates are relatively low by OECD standards. This is only possible because the tax base is broad.

2.7 An alternative approach would be to provide tax incentives for employee share schemes.
Should tax incentives be offered for employee share schemes?

2.8 As noted above, employee share schemes 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.

2.9 A prima facie case for the Government to provide some form of subsidy, possibly tax incentives, arises if an activity produces positive externalities – that is, benefits arising from an activity (or a transaction) that are not enjoyed by the parties involved, but by a third party. Without some sort of Government incentive, less of the activity/transaction would occur than is ideal from society’s perspective, as the wider benefits are typically ignored by those undertaking the activity/transaction.

2.10 An example of a positive externality is a beautiful home garden. A beautiful garden improves the home of the homeowner but also improves the character of a street for all who live on it. However, this wider benefit typically is not taken into account by homeowners; many homeowners do not create a garden even if society would be better off if they did.

2.11 Externalities can also be negative, in which case a special tax would be applied to the offending activity under the same logic justifying incentives.

2.12 The 2001 *Tax Review* noted that, as a practical matter, it is difficult for the tax system to identify positive externalities. Moreover, because positive externalities are common, subsidising an activity on externality grounds would invite lobbying to support other activities on the same grounds. The *Tax Review* noted:

> A practical difficulty with the externality theory, however, is that such effects are pervasive, and it is generally impossible to measure either the relevant external effects or the effects of the intervening government measure. Many economists argue that government intervention typically worsens rather than improves national welfare because of infirmities of the political market. These concerns about externality-based interventions are compounded by the fact that the widespread existence of externalities provides a platform for practically any lobbyist’s reform agenda.

2.13 For this reason the 2001 *Tax Review* suggested a high burden of proof is required before providing tax incentives on externality grounds.

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4 Ibid at pp 22.
2.14 This high burden of proof is not met for employee share schemes. It is unlikely that employee share schemes generate significant positive externalities. While these schemes can provide benefits (higher productivity, better engagement), these benefits are likely to be fully captured by the parties to the transaction (the employer and the employee). Higher productivity will increase profits for the employer, and likely increase remuneration for employees. An employee share scheme is unlikely to generate a greater positive externality than a simple cash bonus dependent on share price performance.\(^5\)

2.15 If employee share schemes do not generate significant positive externalities compared with cash remuneration, then providing tax incentives for them would reduce New Zealand’s welfare. Incentives would lead to employee share schemes being excessively used when this would not be attractive under a more neutral tax regime. They would reward firms that are able to provide remuneration by means of employee share schemes ahead of other firms. They would also be unfair, as employees of such firms would more easily be able to earn income by way of employee share scheme benefits and therefore bear a lower tax burden than employees of other firms earning equivalent cash remuneration. Moreover, it is difficult to target tax incentives, so that the benefits would likely spill over to arrangements that do not satisfy the intent underlying the granting of the incentives.

2.16 For these reasons we consider that tax neutrality is the best framework for deciding how to tax employee share schemes, as providing tax incentives for these schemes would be detrimental to New Zealand’s national welfare.

**Taxing employment income consistently**

2.17 Salary and wages are taxed on a cash basis – that is, an employee derives the income, and is therefore liable for tax, when it is paid to them.\(^6\) This is also true of other forms of employee remuneration paid in money, such as cash bonuses. If an employee is promised a $10,000 bonus if they remain employed for three years, no tax is payable until they receive the bonus. If they fulfil the condition and are paid the bonus, the full $10,000 will be taxable in the year it is paid. No tax is payable before the condition is fulfilled and bonus paid.

2.18 There are other ways of rewarding employees, for example through employee share schemes. Tax neutrality requires income arising from share schemes to be taxed similarly to income arising from payments of cash. This ensures that tax does not affect how employees are best rewarded – they will be rewarded in the way that makes the most commercial and economic sense.

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\(^5\) In support of this conclusion, see *The Taxation of Employee Stock Options* (OECD) 2005 at p11.

\(^6\) Though in the unusual case where cash remuneration is paid in advance of the provision of employment services, it is likely that the income is derived only once those services are provided.
Example 1

Jim has a tax rate of 33%. If his employer offers him a $1,000 bonus if he is still working for the employer in a year’s time, he will receive a net $670 in one year and $330 tax will be withheld.

If instead his employer decides to pay Jim the same bonus in shares, the tax-neutral outcome⁷ (assuming the shares are not subject to PAYE) would be for the employer to provide $1,000 of shares, and for Jim to pay $330 tax (this assumes there is no cash gross-up provided by the employer with the shares).

In both cases Jim receives $1,000 of before-tax income and has paid $330 of tax. Tax will not be a factor in how Jim wants to be paid.

2.19 Consistent treatment of employment income is not simply a matter of ensuring that employee share scheme benefits are treated as taxable income. It is also important that the timing and amount of the income is determined consistently with the timing and amount of other forms of remuneration, most obviously cash.

Example 2

Suppose that in the previous example, instead of offering Jim a $1,000 bonus in one year, Jim’s employer promises him 1,000 shares if he is still with the company in one year. At the start of the year, when the offer is made, the value of the shares is $1 per share. Suppose when the bonus is paid, the shares are worth $1,500 in total or $1.50 per share.

It clearly would not be appropriate for Jim to pay tax on only $1,000 of income in that case. $1,000 is the value of the shares when the offer was made, not when they are received. Jim should be taxed on $1,500, that is, the value of the shares when they are received and taxed. This is the same amount of income as Jim would have if his employer offered him a cash bonus equal to the value of 1,000 shares in a year. The principle is the same if the shares are worth only $0.80 when they are provided to Jim. In that case he should be taxed on only $800.

2.20 Taxing employee share scheme benefits using the share value at a time different from the time when the benefit is received is particularly undesirable from a neutrality perspective if it leads to an expected under-taxation or over-taxation of the benefit. As will be explored in more detail in Chapter 5, systematic under-taxation of the income can arise in circumstances where there is some contingency in the receipt of the benefit.

⁷ Under current law, this transaction is not tax-neutral because there is no deduction for the employer. However, as discussed below we propose that the law should be changed so a deduction is allowed.
Establishing the border between income and capital gains

2.21 A fundamental issue in the taxation of certain sophisticated arrangements with option-like effects is establishing the appropriate border between income and capital gains treatment for the income earned under the scheme.

2.22 While New Zealand has a broad-based tax system, it does not have a general tax on capital gains. Accordingly, there is a benefit to be gained if taxable employment income can be recharacterised as a tax-free capital gain.

2.23 In ensuring neutral treatment between different ways of earning employment income, it is important to correctly determine the nature of that income, as capital gains or employment income. This is the central point at issue in the discussion of the taxation of option-like arrangements in Chapter 5.

2.24 The proposals in the following chapters seek to make this borderline clearer in concept and application.

Treatment of employer costs

2.25 In order to provide neutral taxation, employer costs of issuing employee shares schemes should be deductible to the employer to the extent they are taxable to employees. This would parallel the treatment of employment income paid in cash. Otherwise there is a bias against using employee share schemes, which would be inconsistent with the neutrality framework.

Submission points

We are interested to hear from readers whether they agree that a neutral framework is the best framework for assessing the tax treatment of employee share schemes. If not, why not, and what would be a preferable framework?
CHAPTER 3

Employer deductions for shares provided under employee share schemes

3.1 Under current law there is no explicit deduction for a company that issues shares to an employee at a discount. This is not appropriate. In principle, employers should be able to claim a deduction for providing employee compensation in the form of shares, just as they can claim a deduction for other types of remuneration. Providing a deduction would ensure that the tax system does not act as an impediment to paying staff in the most sensible manner.

Neutral treatment

3.2 In the absence of income taxes, it is worthwhile paying an employee $1,000 if that employee will increase company revenue by $1,001. In the presence of taxes, it remains sensible to hire the employee only if the salary is deductible. If it is deductible, the company will be taxed only on its $1 profit – it will be profitable to hire the employee in the same circumstances after tax is imposed as before tax is imposed. If the salary is not deductible, the company will face tax on income of $1,001, despite making only $1 of profit. It would not be profitable to hire the employee.

3.3 Similarly, in the absence of tax it is worthwhile providing an employee with $1,000 of shares if this would incentivise the employee to increase revenue by $1,001. In the presence of tax, it is necessary to allow an employer a deduction for the provision of shares in order to maintain tax neutrality. Without a deduction, the employee would have to increase revenue by at least $1,390 in order for it to be worthwhile (for the company) to provide $1,000 worth of shares.8

3.4 Allowing employers a deduction for remuneration in shares is important to ensure tax neutrality. It equalises the tax treatment of employee share scheme benefits with cash remuneration, which is deductible to the employer. If a deduction is available for cash remuneration but not remuneration in shares, the tax system will discourage the use of employee share schemes.

Costs when shares provided

3.5 In general, the costs of issuing a share are not deductible as they do not represent a cost to the company. The value of the shares is supported by the extra cash the company receives as a consequence of selling the shares. However an employee share scheme is a different transaction. The transaction could be viewed as payment of a cash wage to the employee,

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8 If the company earns $1,390 and pays tax at 28%, it will clear $1,001. This will yield a $1 profit after providing the employee with the shares.
followed by the purchase of shares of the company. The cost being deducted is not for the issuance of the share, per se, but the implicit cash wage that the share represents.

3.6 In some circumstances, it is possible under current law for an employer to structure employee share schemes so deductions are available. However, this is an unsatisfactory solution. Such employee share scheme structures may be costly and complex and could also be seen as tax avoidance. The amount and timing of the deduction may be different from the amount of income to the employee. For these reasons, not all employers offering employee share schemes may be able to or want to structure them so that the amount treated as income to the employee is also deductible to the employer. This creates a barrier to otherwise beneficial employee share schemes.

3.7 The fact that the issue of shares by a company does not involve an explicit cash cost to the company itself does not affect the above analysis. The deduction reflects the transfer of value to the employee, which arises whether that value is transferred as cash or as shares in the company. In contrast, in the case of shares issued for consideration, there is a dilution cost to the existing shareholders in the company when shares are issued as part of an employee share scheme. Under the corporate tax system, where company expenses are deducted by the company as a separate taxpayer from its owners, this cost must be recognised in the calculation of income by the company rather than the shareholders on whose behalf it is earned.

3.8 Recognition of expenditure arising from the issue of shares and options to employees is now required under International Financial Reporting Standards (IFRS), though on a different basis to that proposed here.9

Proposed deduction

3.9 It is proposed that employers be allowed a cost for the provision of shares under employee share schemes to the extent that they give rise to employment income taxed in the hands of employees in the year.

3.10 Clear availability of this deduction, and its linkage to taxation of the employee, may well assist in reducing concerns about the amount and timing of employee share scheme income to employees, and also in reducing the incentive to find ways to artificially reduce or defer employee share scheme income. It also ensures the deduction is available to the employer without having to structure the employee share scheme to achieve deductibility.

3.11 Consequential amendments would be required to ensure that no other costs with respect to the provision of the shares are deducted by the employer. Other consequential issues would also need to be considered – for example, the effect of employee share schemes on the employer’s available subscribed capital.

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9 IFRS are the international accounting standards that specify the basis on which certain types of businesses are to prepare their financial accounts.
Submission points

We are interested to hear from readers:

- whether the current non-deductibility of employee share scheme benefits is a barrier to offering employee share schemes in practice;
- whether clarifying the basis for a deduction is desirable;
- whether readers agree that the appropriate approach to quantifying and timing the deduction is to match it to the employment income recognised by the employee. If not, why not, and what would be preferable approach?
- whether the approach should be modified where the employer is not the direct provider of the shares, for example, where there is a trust involved, or where the shares are issued by the ultimate parent company of the employer.
CHAPTER 4

Taxing employment income from unconditional employee share schemes

4.1 As described in Chapter 2, tax neutrality requires that the benefits provided to employees under employee share schemes are taxed consistently with other forms of remuneration.

4.2 As previously noted, employee share schemes may be divided into three general categories:

- *Unconditional* employee share schemes – which provide shares or options free from further conditions.

- *Conditional* employee share schemes – where the shares or options received are subject to future employment conditions.

- *Option-like arrangements* – which 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.

4.3 This chapter discusses the current taxation of unconditional employee share schemes. In general, under current rules, unconditional employee share schemes are taxed in a manner which is consistent with the policy framework in Chapter 2. It provides context for the discussion in Chapter 5 of conditional employee share schemes and option-like arrangements.

4.4 Broadly, unconditional employee share schemes fall into two categories:

- share purchase plans, where an employee purchases (or is given) shares; and

- share option plans, which are in effect deferred share purchase plans.

**Share purchase plans**

4.5 Employees participating in a share purchase plan are taxed when they acquire the shares. 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.

4.6 We consider that this treatment is appropriate when shares are received without further conditions. Income is earned at the time the shares are acquired in much the same way as income would have been earned if paid as salary and wages and the proceeds used to acquire shares of the company.
4.7 The concerns of start-up companies with the taxation of share purchase plans are discussed in Chapter 6.

**Share option plans**

4.8 With a share option plan, employees are given a right to purchase shares at some future date for a set price (the strike price). An employee will exercise the option if the shares’ price 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’ price the employee will not exercise their option.

4.9 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.

4.10 Under current rules, no tax is paid when the option is issued. 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 value at the strike price is taxable income. This approach is tax at exercise.

4.11 In principle, an employee participating in a share option plan could be taxed when the options are provided to them. No further tax would be paid when the option is exercised. This approach is tax at issue.

4.12 Concerns have been expressed that tax at exercise taxes the potential share price increase when compared with tax at issue; that is, tax at exercise taxes capital gains. These concerns are misplaced. The two tax treatments are equivalent. They lead to the same distribution of after-tax outcomes for the employee for all share price outcomes. Accordingly, the current tax treatment of employee share options is consistent with New Zealand’s general capital gains tax policy.

4.13 This result is counter-intuitive. Certainly more tax is paid when prices increase. But the bottom line is that the after-tax outcomes of the employee are the same under the two approaches.

4.14 This result is illustrated with Example 3, with shares that can increase or decrease in value by 50 percent in a year’s time with equal probability.

4.15 The essential difference between the two approaches is the after-tax amount available to be held as options by the employee, when equivalent compensation packages are compared. With tax at issue, tax must be paid on the employment income. Only the after-tax amount of income is available to be held in options. Under tax at exercise, no tax is paid when the option is provided, so the entire before-tax amount of income can be held in options.

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10 The example assumes an interest rate of zero for simplicity, but the results are not affected by this assumption.
4.16 Under the assumptions, shares worth $100 currently would be worth either $150 or $50 in a year’s time. An option on the shares with a strike price equal to the current price is worth $25; that is, the 50 percent probability of receiving $50 = $150 - $100. Thus when the share price increases by 50 percent, the option doubles in value from $25 to $50. If the share price falls, the option is worth nothing.

4.17 Assume that the company wishes to provide compensation in the form of options that would be equivalent to pre-tax cash wages of $25. With cash wages, the employee would pay $8.25 in tax,11 and receive an after-tax benefit of $16.75.

4.18 Under tax at issue, an equivalent option scheme would result in tax being paid of $8.25 and an after-tax amount of $16.75 held as an option on the shares of the company. Under the price assumptions, the option yields a benefit of $33.50 (twice $16.75) when the share price increases. No further tax is paid when the option is exercised. If share prices fall, the option is not exercised.

4.19 With tax at exercise, no tax is paid when the option is provided, so the entire $25 can be held as an option. The option yields a before-tax profit at exercise of $50 (twice $25) when share prices increase, with tax payable of $16.50 (= .33 x $50). The net after-tax benefit is $33.50 (= $50 - $16.50). If share prices fall, the option is not exercised.

Example 3: Taxation of unconditional options

<table>
<thead>
<tr>
<th>Period 1</th>
<th>Period 2</th>
<th>Price outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price of shares</td>
<td>$100</td>
<td>$150</td>
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<td></td>
<td>$50</td>
<td>Low price</td>
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<tr>
<td><strong>Tax at issue</strong></td>
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<tr>
<td>Pre-tax benefit</td>
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<td>$33.50</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td>Tax paid</td>
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<tr>
<td></td>
<td></td>
<td>$0</td>
</tr>
<tr>
<td>After-tax value of benefit / Option held</td>
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<td>$33.50</td>
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<tr>
<td></td>
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<tr>
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</tr>
</tbody>
</table>

4.20 The example demonstrates that tax at issue and tax at exercise result in the same pattern of after-tax cashflows. The basic point is that it makes no difference if a tax rate of 33% is applied when the option is provided or if the 33% rate is applied when the proceeds are received. Either way tax reduces the employee’s final holdings of shares by 33%.

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11 A tax rate of 33% is assumed in all examples.
4.21 Because the employee’s after-tax benefit from the arrangement is the same regardless of whether tax is imposed at issue or at exercise, they should be indifferent between the two taxing points.

4.22 This is notwithstanding that more tax, $16.50, is paid in high price situations under tax at exercise than under tax at issue (tax of $8.25). Reducing the shares held by $8.25 in the first period with tax at issue has the same effect on the employee’s final holdings as taxing the full amount of the proceeds under tax at exercise.\(^\text{12}\)

4.23 The equivalence of tax at issue and tax at exercise reflects the standard public finance result that taxing income as it is earned and investing the after-tax amount free from further tax is equivalent to investing the before-tax income and taxing the entire proceeds when they are realised in the future.\(^\text{13}\)

**Maintaining the current approach**

4.24 The current taxation of employment income from unconditional employment share schemes is consistent with the framework and no changes are proposed.

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**Submission points**

We are interested to hear from readers:

- whether they agree that the current tax treatment of unconditional employee share schemes (including employee share options) is appropriate and does not require reform;
- if you disagree with any of the above, why and what your preferred approach would be;
- whether there are any technical or remedial issues with respect to the employee share scheme rules that could be addressed as part of any legislative reform.

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\(^{12}\) On average, over high and low price outcomes, the government collects the same amount of tax whether tax is imposed at issue or on exercise. However, the government accepts a more risky revenue stream if it taxes on exercise since it only receives tax in high price worlds.

\(^{13}\) Essentially this is the standard TEE equals EET result for deferred tax schemes.
CHAPTER 5

Proposed taxation of conditional employee share schemes and option-like arrangements

5.1 This chapter discusses the problems associated with conditional employee share schemes before addressing option-like arrangements. For conditional employee share schemes, the timing of taxation may differ from other forms of employment income. In some cases, the expected level of taxation may also be different. For option-like arrangements, employment income may be derived that would be taxable if it were in the form of an equivalent option or a conditional bonus. However under the current treatment of the arrangement, this employment income may escape taxation altogether. Further examples of conditional employee share schemes and option-like arrangements are contained in Appendix 1.

5.2 The chapter puts forward a proposal to address the timing and under-taxation problems. The proposal does not affect the taxation of the income of employees arising from unconditional employee share schemes.

Taxing conditional employee share schemes

5.3 Unconditional employee share schemes are granted without a stipulation that the employee continues in employment with the company. As the receipt of the shares does not depend upon performing any services in the future, they can be seen as a reward for past employment services, and their tax treatment reflects this.

5.4 However, a conditional employee share scheme shares many characteristics with conditional cash bonuses or other forms of remuneration. In particular, the services that the contract rewards have not yet been performed and the associated employment income not yet earned. It effectively provides a reward for future work.

5.5 Under current law, a conditional employee share scheme may, at times, be disadvantaged compared with a conditional cash bonus. Currently, a conditional employee share scheme has a different taxing point to a conditional bonus providing an equivalent employment benefit. Consider a share, worth $100, acquired in Period 1 for no consideration, subject to forfeiture if the employee is not employed at the end of Period 2. Currently, $100 would be taxed in Period 1. If the employee leaves before the end of Period 2 (thus forfeiting the share), this income would be reversed for tax purposes, but the employee would have been out of pocket for the tax over the period.

5.6 In effect the tax would be payable before the services were rendered and before any remuneration was earned. An equivalent cash bonus and its tax would only be payable in Period 2.
5.7 On the other hand, Example 1 in Appendix 1 outlines situations where the expected value of tax could be reduced by using a conditional employee share scheme in combination with an interest-free loan and a bonus.

5.8 Current law already deals satisfactorily with share options where the right to exercise is conditional on remaining in employment (the employee share scheme benefit is taxed on exercise).

**Taxing income from option-like arrangements**

5.9 Option-like arrangements have more complicated features than other conditional employee share schemes. Features can include interest-free non-recourse loans and various mechanisms to return the shares if conditions are not met. More examples of option-like arrangements are contained in Appendix 1.

5.10 Under an option-like arrangement:

- an employee purchases shares in the company, but retains the shares only if certain share price-related conditions are met;\(^{14}\)
- because of the price conditions, the arrangement has a positive expected value at the time of issue;
- if the conditions are not met, the shares are forfeited, but there is no loss to the employee;
- as the arrangement is remuneration for employment services, the value is employment income and should be taxed;
- however, the effect of the arrangement is to bring forward the taxing point to a time prior to the satisfaction of the conditions;
- under current law, the arrangement is viewed as a purchase of shares for full consideration;
- accordingly, no income is subject to tax at issue;
- any income arising from price movements of the shares between the time that they are purchased and the satisfaction of the condition is tax-free; and,
- as a consequence, taxable employment income is converted into tax-free capital gains.

5.11 The cashflows of this type of arrangement can be equivalent to the cashflows of an option that would give rise to tax. Or, they can be the same as a conditional cash bonus where the amount of the bonus depends on the price of the shares (sometimes referred to as a phantom share scheme).

\(^{14}\) There are also typically employment conditions.
5.12 Given the income arises from a benefit which is conditional on future services, it is appropriate that it be taxed at the same time as other equivalent forms of employment income.

5.13 Consider Examples 4 and 5 which compare the taxation results of an option and an option-like arrangement under current law. In the examples, the option-like arrangement results in no tax. This is despite the fact that $25 of income has been provided to the employee by the employee share scheme. By contrast, the equivalent option yields $25 of expected taxable income. The examples are based on the price situation used in Example 3.

**Example 4: Taxation of option**

The share prices movements are the same as in Example 3. In this case, the employee is given a share option that is exercisable with a strike price of $100 if they continue in employment for one year. The expected value of the benefit is $25 (that is, a 50 percent chance of getting $50).\(^{15}\)

<table>
<thead>
<tr>
<th>Period 1</th>
<th>Period 2</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share price</td>
<td>100</td>
<td>150</td>
</tr>
<tr>
<td>Employee cashflow</td>
<td>0*</td>
<td>50**</td>
</tr>
<tr>
<td>Taxed income</td>
<td>0</td>
<td>25</td>
</tr>
</tbody>
</table>

* the employee receives a benefit of an option worth $25, but no cashable benefit
** $50 is the difference between the strike price of $100 and the share value of $150 in the high-price state of the world. In the low-price state of the world, the share value of $50 is less than the strike price and the option is not exercised by the employee.

**Example 5: Taxation of option-like arrangement**

The facts are the same as in Example 4, except that, instead of issuing an option, the employer issues shares to the employee for $100, funded by an interest-free loan. There is zero net cashflow for the employee in period 1, which is the same as the option in Example 4.

If the price is $150 in period 2, the employee keeps the shares and repays the loan. Net income and benefit are $50, the same as the option in Example 4.

But the benefit in this example is treated as a capital gain and no tax is payable under current rules.

If the share price falls to $50, the employee hands back the share in satisfaction of the loan, with no taxable income or loss if the documents are appropriately drafted.

<table>
<thead>
<tr>
<th>Period 1</th>
<th>Period 2</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share price</td>
<td>100</td>
<td>150</td>
</tr>
<tr>
<td>Employee cashflow</td>
<td>0*</td>
<td>50**</td>
</tr>
<tr>
<td>Taxed income</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

* $100 loan advanced minus $100 purchase price.
** $150 share minus $100 loan repayment.

\(^{15}\) If the share pays a dividend during the year after it is given, the employee receiving the employee share scheme benefit will also receive the dividend. However, the employee will in that case be taxed on the dividend, so this difference in outcomes is appropriately taxed.
As noted above, some concerns have been expressed that tax at exercise taxes the potential share price upside more than tax at issue. Under tax at issue, the same $25 of income would be subject to tax, in contrast to the option-like arrangement which results in no tax. As discussed in detail in the chapter on unconditional employee share schemes, tax at issue and exercise are equivalent, and in any event are not relevant to the conclusion that option-like arrangements can lead to under-taxation under current rules.

Summary of problems

The current tax treatment of conditional employee share schemes and option-like arrangements is not appropriate when tested against the framework described in Chapter 2. Specifically, inconsistency between the taxation of conditional employee share schemes, option-like arrangements and other forms of employee remuneration can arise if:

- shares are subject to forfeiture if the employee does not continue to provide services for a certain time;
- there is downside price protection on the shares; or
- shares have contingent rights that make them hard to value on issue.

In all cases, income can be considered to be earned when the conditions are satisfied (or the downside protection ceases) and value is received. However, under current rules, taxation may occur at a prior point. For option-like arrangements and shares with contingent rights, early taxation may result in some employment income not being taxed.

The current rules are also a source of considerable complexity and uncertainty as economically equivalent transactions can have a significantly different tax treatment depending upon arbitrary and obscure technical differences. The current rules lack clear legislative guidance on which to base consistent determination of treatment.

Proposal to clarify taxation of conditional employee share schemes and option-like arrangements

The objective of the proposal is to clarify the tax rules applying to employee share schemes to:

- ensure that the amount of taxable income reflects the employment income arising from the arrangement;
- ensure consistency with the taxation of other equivalent forms of employment income;
- eliminate uncertainty of application; and
- ensure employers can use employee shares schemes where they are economically efficient.
5.19 The proposal directly addresses the problem of the taxing point occurring before the income is actually earned. It defers the time of taxation until all of the substantial conditions have been fulfilled. We refer to the proposal as a “substantial conditions” approach. It would clarify the taxation of complex schemes, and would generally align the taxation of employee share scheme benefits with the taxation of equivalent benefits provided in cash.

5.20 By clarifying the taxation of complex arrangements, it will eliminate uncertainty and simplify compliance and administration.

Technical issues

5.21 Deferral of income recognition would apply generally when the employee does not have all the risks and rewards associated with share ownership.\(^{16}\) For example:

- when there is a real risk of forfeiture of the shares;
- where the employee has a right to transfer the shares back to the company (often in satisfaction of a loan used to acquire the shares);
- where the employee is protected against loss due to a decline in the share price, for example, by way of a non-recourse loan or other payment;
- when employment-related conditions have not been satisfied; and
- when contingent rights associated with the shares have not been exercised or extinguished.

5.22 Not all conditions would be considered to be substantial. For example, a sale restriction alone should not be considered to be a substantial condition that gives rise to deferral of tax, nor should it be taken into account in valuing employee share scheme benefits.\(^{17}\) This is because sale restrictions are very difficult to value, and if they were taken into account to reduce the assessable income under an employee share scheme, when the sale restriction was removed, the remaining value of the shares would need to be taxed at that point. This approach seems overly complex and compliance cost-heavy.

5.23 If the substantial conditions approach is adopted, a number of technical details would need to be worked through during the legislative process. In particular, deferring the taxing point for shares may also require legislation to deal with other possible events that might occur before a condition is fulfilled, but that should nevertheless trigger recognition of employment income. Such events include:

\(^{16}\) If an employee simply acquires ordinary shares in their employer using a loan (interest-free or otherwise) from the employer and there are no other arrangements relating to the shares, for example, substantial contingencies attached to the shares, or downside protection, then the shares will be treated as acquired by the employee at the outset of the arrangement. This treatment is consistent with the position of other equity investors in the company who have borrowed (at full recourse) to purchase shares.

\(^{17}\) Contrary to the current rules in section CE 3 of the Income Tax Act 2007.
termination of employment where shares or options are retained (often they will not be);

migration by the employee;

expiry of a certain number of years; or

the condition becoming insubstantial.

5.24 It is important that the new rules cannot be circumvented, either by avoiding an employment relationship, or having shares or options issued directly to an associated person of an employee, rather than the employee themselves. For example, suppose a person provides personal services to an employer through a personal services company and the company receives shares as part of the remuneration for those services. Prima facie, because the company is not an employee, the taxation of those shares will not be determined by the proposed rules. Some form of anti-avoidance provision would be appropriate to ensure that the new rules do apply in such a situation, perhaps adopting a similar approach to the existing personal services attribution rules.

5.25 There will be other technical or remedial issues that should be dealt with if and when the legislation is amended. These issues could include:

- the anomalous treatment of convertible notes under the employee share scheme rules;
- clarifying the cost base of the shares for the employee;
- any cross-border issues peculiar to employee share schemes; and
- any uncertainties that exist in the way employee share scheme trusts are currently taxed.

**Submission points**

We are interested to hear from readers:

- whether they agree that the current tax treatment of conditional employee share schemes and option-like arrangements is at odds with the neutral framework outlined in Chapter 2; and

- whether they agree with the “substantial conditions” approach to taxing employee share scheme benefits.

If you disagree with any of the above, please outline why and what your preferred approach would be.
CHAPTER 6

Start-up companies

6.1 Employee share and option schemes can be an attractive form of remuneration for start-up companies, such as technology companies, as they allow companies to reward employees with the prospect of future share price gains rather than payment of cash wages and salaries. Tax rules are sometimes seen as a barrier to start-up companies using these schemes.

6.2 In particular, concerns have been raised that if the tax impost arises without a sale or an active market for the shares, it is difficult to determine their value so as to work out the tax liability. Even if the shares can be valued, the employees are often unable to sell a portion of their shares to meet the tax liability and therefore have to fund the liability from other income or borrowings – thus making the scheme less attractive. In principle, the employer could provide cash income to pay the tax. But, start-up companies typically experience cashflow problems as well and therefore the problem is simply transferred to the employer.

6.3 The lack of deductibility of costs associated with the issuance of shares may also deter their use as the after-tax cost of providing share-based compensation is higher than alternative cash-based compensation that would give rise to a deduction.\(^\text{18}\) The proposal to allow an explicit deduction – discussed in Chapter 3 – would remove this disincentive.

6.4 There may also be other tax issues that hinder the ability of start-up companies to offer employee share schemes.

Submission points

We are interested to hear from readers:

- whether valuation and liquidity issues are barriers to start-up companies offering employee share schemes; and
- whether there are other tax obstacles to start-up companies offering employee share schemes.

\(^\text{18}\) For start-up companies without income, the tax deduction may not be useable until sometime in the future.
Timing of taxation

6.5 The fundamental tax issues for start-up companies offering employee share schemes concern the timing of taxation. These issues can be illustrated with a simple example that modifies the examples in the previous chapters to better reflect a start-up company’s situation. Assume that shares with a current value of $100 will be listed on the stock exchange at a value of $1,000 in period 10, 10 percent of the time. Otherwise the company fails and the shares will be worth nothing. Over the period, the start-up company pays no dividends. Again, assume for simplicity a zero interest rate. This situation is illustrated in Example 6.

<table>
<thead>
<tr>
<th>Example 6: Start-up company share valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Period 1</td>
</tr>
<tr>
<td>High value</td>
</tr>
<tr>
<td>Low Value</td>
</tr>
<tr>
<td>Average value</td>
</tr>
</tbody>
</table>

6.6 Companies have considerable flexibility in determining the timing of taxation of employee share scheme benefits through their choice of scheme. The company can choose between providing discounted shares and paying tax upfront or providing an option that is taxed when it is exercised (at which time valuation and cashflow problems may be resolved). Example 7 demonstrates that the distribution of the net of tax benefits to the employee over different share price outcomes is the same.

6.7 Consider an unconditional employee share purchase scheme offered with a full discount. The $100 benefit would be subject to tax when the share is issued, so that the after-tax amount of shares held would be $67.

6.8 Alternatively, the company could offer an option over the share with a strike price of zero, exercisable if there is a liquidity event (assumed to be in year 10). A liquidity event, such as public listing of the shares or a large trade sale would avoid valuation and liquidity problems. The full $100 of value could be held as an option.
Example 7: Deferral of taxation
The table compares the net of tax outcomes from receiving a fully discounted share or a fully discounted option.

On one hand, the employee receives $67 of shares at a full discount on which tax of $33 has been paid upfront; equivalent to $100 of income. In period 10, either:

(a) the underlying shares increase in value to $670; or,
(b) the shares drop in value to zero.

On the other hand, if the employee receives $100 of options in Period 1, but does not pay tax until Period 10, then either:

(a) the shares go up in value, the employee buys $1,000 worth of shares for $0, makes a pre-tax gain of $1000 and, after paying tax of $330, ends up with $670 of shares; or
(b) the shares go down in value to zero.

The employee’s after-tax benefit in both the high price and low price states of the world is the same regardless of whether they pay tax upfront on a fully discounted share purchase or pay tax at exercise on a fully discounted option.

<table>
<thead>
<tr>
<th>Period 1</th>
<th>Period 2</th>
<th>High price (shares worth $1000) or low price (shares worth $0)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax on share purchase</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Before tax benefit</td>
<td>$100</td>
<td>$670</td>
</tr>
<tr>
<td>Tax paid</td>
<td>$33</td>
<td>$0</td>
</tr>
<tr>
<td>After-tax value of benefit</td>
<td>$67</td>
<td>$670</td>
</tr>
</tbody>
</table>

| | | Low price |
| **Tax on share option** | | |
| Before tax benefit | $100 | $1000 | High price |
| Tax paid | 0 | $330 | Low price |
| After-tax value of benefit | $100 | $670 | High price |

The example demonstrates that for start-up companies that do not pay dividends, where the employee receives the shares at a full discount, there is a simple way under current rules to avoid valuation and cashflow problems, while yielding equivalent after-tax benefits to the employee.
Submission point

We are interested to hear from readers whether this flexibility in the choice of scheme structure is likely to be sufficient to resolve the liquidity and valuation issues for start-up companies, or whether there is a need for legislative solutions to be explored.

Possible statutory deferral for start-ups

6.10 If valuation, liquidity and possibly other issues are likely to continue to present a significant barrier to start-up companies offering employee share schemes, we would like to explore ways to ameliorate these tax issues within the proposed framework (discussed in Chapter 2). To be consistent with the policy framework, any proposals should not result in material under-taxation of employment income nor increase the risk of non-compliance.

6.11 For example, a possible way to address the valuation and liquidity problems would be to allow employees of start-up companies who receive shares under an employee share scheme to defer the taxing point until the shares are sold or listed. This would address both the valuation and liquidity issues – at the time the shares are sold, there is an established market value and the employee has cash with which to satisfy the tax liability. Ordinarily income received in-kind is recognised when received rather than being deferred until the asset is sold.

6.12 This potential deferral differs from the self-help deferral discussed above (that is through using an option scheme), since, in this case, the employee actually receives the shares. With an option, the receipt of the shares is delayed.

6.13 Under a statutory deferral approach, income tax would be imposed at the time the shares are sold on the sale price of the shares less any amount the employee paid to acquire the shares.

6.14 Deferral might seem unattractive to taxpayers. Employees entering into employee share schemes will often do so on the basis that they believe the shares might increase significantly in value. If the corollary of deferring the recognition of income from the receipt of shares in an employee share scheme is that the taxed income is equal to the value of the shares at the time of the deferred recognition, employees may prefer not to defer.

6.15 Perhaps counter-intuitively, Example 8 demonstrates that, if shares are offered at a full discount, deferral of taxation yields equivalent after-tax outcomes for the employee. As with the discussion on tax at issue versus tax at exercise for options in Chapter 4, the apparent taxation of the capital gains is in fact equivalent to upfront taxation, without the attendant problems of valuation and cashflow. The intuition is that scaling down the amount invested at the beginning through taxation is equivalent to scaling down the benefits by the same percentage through taxation at a later time, such as a sale or listing of the shares.
Example 8: Simple comparison of tax at issue and deferred tax

The employee receives $100 of wages, pays tax (or not if tax is deferred), and invests the after-tax proceeds in shares of the company.

**Tax at issue**

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

The shares go up 10 times to $670.

**Deferred tax**

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

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

**Conclusions**

Tax at issue and deferred tax at sale are equivalent.

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

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

6.16 If the employee makes a payment for the shares, deferral can result in an increase in taxation for the employee. Possible remedies for this can be explored.

6.17 This approach allows the deferral of the payment of tax which could result in an effective decrease in tax revenues to the Government. When no dividends are being paid, the deferral would be expected to be compensated for by the collection of a greater amount of tax (because the shares increase in value over the deferral period). However, if the company pays dividends, the expectation will be that the value of the shares would not increase sufficiently for the increased tax to compensate for the deferral benefit.

6.18 For example, assume a 5% after-tax discount rate and a 33% tax rate. An employer grants to an employee the right to acquire a number of shares in three years for no consideration if the employee is still employed at that time. The option is exercised in year 3 when the shares are worth $900. Ordinarily tax of $297 would be payable at that time. However deferral of payment of tax until the shares are sold would have a cost to the Government if dividends are paid. If dividends of $4519 per annum are paid on the shares, the shares would be expected to remain worth $900. The shares are sold in year 5. If tax of $297 is levied at that time there would be a time value of money cost to the Government (though this cost would be reduced by the benefit of deferring the employer’s deduction).

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19 The tax on dividends is irrelevant for the purpose of comparison as these are taxed with or without deferral.
If the shares did not pay dividends, then the shares would be expected to appreciate by 5% per year to $99220 in year 5, leading to tax of $327 (with a present value of $297) – the same present value of tax as taxing at exercise. Accordingly, the Government would be equally well off if it allowed a deferral of tax until sale as if tax was imposed at exercise.

One possibility would be that deferral could be made available only on shares that do not pay dividends. This may not be too great an issue as many start-up companies do not have the cash to pay dividends in any event. However, tax would need to be triggered once the share starts to pay dividends to avoid the under-taxation issue described above. Providing a precise targeting of eligibility for the deferral to cash-strapped start-ups might also alleviate this concern.

An alternative deferral approach, which would deal with situations with less than a full discount and the cashflow issue – though not the valuation issue, would be to determine the tax liability at the time of vesting, but alleviate the liquidity issue by deferring the payment of the tax until the shares are sold with use-of-money interest (UOMI) applying to the outstanding tax liability.

Any deferral of the taxing point for the employee would need to be matched by a deferral of the proposed deduction for the employer.

Scope of any deferral measure

An important issue to decide is which companies would be eligible to use a start-up concession? There are difficulties associated with defining a “start-up company”. In Australia’s recently enacted start-up concession, a “start-up company” is, broadly speaking, an unlisted Australian company which, along with all group companies, is less than 10 years old and has turnover of less than A$50 million. One issue with this approach is that it creates a “cliff face” – once a company earns $1 more than $50 million or is 10 years and one day old, it is ineligible for the regime. This could, in theory at least, create perverse incentives at the margins – for example, a company would not want to earn more revenue because it would lose eligibility to adopt the deferral approach.

Moreover, the Australian definition seems very broad and would appear to include companies that would not have the same liquidity and valuation problems that start-ups do.

Deferral raises various design issues; most obviously, should it be elective or mandatory. If elective, on what basis (scheme by scheme, employee by employee) and who should make the election? How would PAYE be dealt with in the case of income triggered by a sale? How would the system be made robust, so that if tax is not paid at the usual time, is it collected on deferral? Should there be a “sunset” clause, for example, so income cannot be deferred for more than five years?

 Assuming a compounding 5% appreciation.
**Submission points**

We are interested to hear from readers:

- whether deferring tax until sale or listing would be beneficial;
- whether this option should be limited to non-dividend paying shares;
- which companies should be eligible to adopt the deferral option? How should this class of companies be defined?
- whether providing an option to defer the payment of tax (with UOMI applying) would be beneficial; and
- what are the best answers to the questions raised in paragraph 6.24?

**Administrative measures to remove barriers to the use of employee share schemes**

6.26 There is a range of other measures that could potentially reduce barriers to the use of employee share schemes, particularly by start-up companies.

6.27 Most obviously, keeping employee share scheme taxation simple and predictable, particularly in relation to the relatively simple and straightforward employee share schemes which a start-up company might be expected to enter into, is of considerable value to such companies. This reduces the need for expensive or complex advice.

6.28 Other countries (including Australia) have provided specific safe harbour valuation methodologies to reduce compliance costs associated with valuing shares. The question is whether it is possible to develop methodologies that provide reasonable results.

6.29 For example, valuation methods based on balance sheet information are likely to significantly undervalue a company and this is inconsistent with the employee share scheme framework of neutral taxation. In particular, in relation to start-up companies, intangible assets may constitute a significant part of the value of the business and these assets are generally excluded from the safe harbour valuation methodologies or, if included, are still notoriously difficult to value. Abandoning the usual valuation standard, (ultimately, what would a willing buyer pay a willing seller), has considerable risk. Deferring tax until the sale of the shares would be a more robust way to deal with valuation difficulties. We are interested in readers’ views on this issue.
Another measure recently adopted in Australia is the publication on the Australian Tax Office (ATO) website of sample employee share scheme documentation, along with guidance notes on the implementation of the documentation and the tax consequences.\footnote{This documentation can be found at https://www.ato.gov.au/general/employee-share-schemes/in-detail/standard-documents-for-the-start-up-concession/}

In addition, the ATO partnered with software developer LawPath to create an online tool – “Easy ESS” – that allows employers to quickly and easily generate employee share scheme documentation by filling out a simple questionnaire. The documentation includes an offer letter, a standard form agreement and a board resolution approving the scheme. The tool also allows the employer to assess its eligibility for the start-up concession and has a market value calculator which determines the value of the shares under the ATO’s safe harbour rules. The tool can be accessed at: http://sem.lawpath.com.au/easy-ess/.

Easy ESS also advises employers about disclosure requirements under the Australian Corporations Act (as in New Zealand, employers must provide employees with certain information before they participate in an employee share scheme). This means the employer can access the information it needs to offer an employee share scheme (about both its tax obligations and its general corporate law obligations) in one place.

Submission points

We are interested to hear from readers:

- how valuation and liquidity issues are currently dealt with in practice;
- whether readers think providing approved valuation methodologies are possible and would result in reliable and robust valuations;
- whether the provision by Inland Revenue of standard documentation and guidance would be helpful;
- whether an online tool like the Australian Easy ESS would reduce the costs associated with offering an employee share scheme – thus reducing barriers to offering such schemes;
- whether it would be useful to have a tool/guidance covering both the tax and securities law requirements for offering an employee share scheme; and
- whether there are any other options to address barriers to offering employee share schemes that fit within the proposed framework.
CHAPTER 7

Concession for widely offered share purchase schemes

7.1 The Income Tax Act 2007 currently provides a concessionary regime to encourage employers to offer shares to employees under certain widely-offered employee share schemes.

Tax benefits provided by the concessionary regime

7.2 There are two main 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.

7.3 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).22

Requirements of the concessionary regime

7.4 The main requirements of the concessionary regime are:

- the cost to employees of shares made available for purchase must not exceed their market value at the date of purchase (but may be less);

- the amount that an employee spends on buying shares under the scheme (or a similar scheme) must not exceed $2,340 within a three-year period;

- every full-time permanent employee must be eligible to participate in the scheme on an equal basis with every other full-time permanent employee. If the scheme applies to part-time employees or to seasonal employees, they must also be eligible to participate on an equal basis with every other part-time employee or every seasonal employee;

- any minimum period of service which may be required before a full-time permanent employee becomes eligible to participate must not exceed three years (or the equivalent of three years full-time service);

- loans to employees for the purchase of shares must be free of all interest and other charges;

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22 The majority of employee share scheme loans are exempt from FBT for the reasons explained in Appendix 2.
• the repayment of loans by employees is to be by regular equal instalments at intervals of not more than one month over a period between three and five years from the date of the loan; and
• a trustee must hold the shares on trust for the employee for a period of restriction (generally at least three years).

7.5 The benefits of the regime do not apply to shares given to directors of the company or a person who (with any associated person) holds 10 percent or more of the issued capital of the company.

Period of restriction

7.6 The period of restriction is the period that employees are prohibited from charging or disposing of their rights or interests in the shares. There are a number of different time periods specified in the concessionary regime provisions.23

After period of restriction

7.7 On the expiry of the restrictive period, the employee has two options. First, the employee can opt to have the shares transferred from the trust to them. Secondly, the employee can opt for the trust to buy the shares back at the market value (but not more than the price paid by the employee). These options incentivise the employee to hold onto the shares and not sell them back to the trustee, because the maximum amount they can obtain from selling them back is the amount they paid for them. If they hold onto the shares, they continue to have a shared interest in the success of the company.

Issues with current law

7.8 There are various issues with the current concessionary regime:
• the concessionary nature of the regime appears to undermine fairness, tax neutrality and economic efficiency;
• the reasons for introduction of the regime may no longer be valid;
• the regime is complex and inflexible;
• the tax benefits of the regime are uncertain and poorly targeted;
• the regime does not limit the amount of tax-free benefit that can be conferred;
• there are some drafting issues with the legislation; and
• the maximum amount an employee can pay for shares ($2,340 over a three-year period) has not been adjusted since 1980, and this means as a practical matter that the benefits available under the regime are very limited. Adjusted for wage inflation, the figure would now be around $13,000.

The reasons for introducing the regime may no longer be valid

7.9 The current concessionary regime was introduced in 1973. It was enacted in the context of a heavily-regulated labour market which meant there was limited ability to directly relate an employee’s salary to the performance of the employer. There was also a high level of industrial unrest at the time of enactment. The purpose of the concessionary regime was to encourage companies to give employees a stake in their industry by issuing shares to them. The Government wanted to encourage a greater identity of interest between the employer and the employee. As noted in the discussion of tax incentives, these benefits are probably captured by the parties themselves and so do not provide a convincing rationale for an incentive.

The regime is complex and inflexible

7.10 The complexity in the regime comes from the various requirements that need to be satisfied in order for an employee share scheme to qualify for concessionary treatment. Specifically, there are various thresholds and timing requirements that must be satisfied (see above). Further, because the regime has various thresholds, and because it needs to apply to all employees equally, the schemes tend to be inflexible. For example, the concessionary regime cannot factor in the remuneration or time worked in determining the number of shares allocated to an employee. Further, when a loan is provided, the repayment instalment periods cannot exceed one month. Likewise, the period of the restriction on the shares is specified in the legislation so it may not reflect an individual employment situation.

The tax benefits provided by the regime are arbitrary

7.11 The deemed 10 percent interest deduction seems anomalous. Why should a company offering interest-free loans under an approved scheme be entitled to a deduction equal to 10 percent of the loans each year? Clearly this is an incentive, but the amount and basis for this particular incentive are not obvious.

7.12 The FBT-exempt status of the loans will also often be of little benefit. In most cases such loans would be FBT-exempt in any event, as “employee share loans” (that is, any loan provided by an employer to an employee to purchase its shares under an employee share scheme). The only benefit of the concessionary regime is that the interest-free loan can be FBT-exempt regardless of the company’s dividend paying policy.

26 See discussion in Appendix 2.
No limit on tax-free benefit

7.13 As noted above, there is an upper limit on the amount of consideration that an employee can pay for the shares in a three year period. However, there is no explicit minimum amount of consideration an employee must pay to be entitled to the shares, nor is there any limit on the value of the shares that may be provided. In the case of a company with a large number of employees, or with employees on quite different remuneration levels, there is a natural limit on the value of the shares that can be provided under a concessionary scheme. However, in the case of a company with a smaller number of broadly equal employees, there may be an opportunity to take advantage of the concessionary nature of the regime. In other words, it may allow very large amounts of employment income to be received tax-free.

Options for reform

7.14 There are three broad options:

- **Repeal the current concessionary regime and retain only the non-concessionary provisions in subpart CE and section CX 35**: This option is consistent with the overall framework set out in Chapter 2.

- **Retain the current concessionary regime**: This option is inconsistent with the overall tax framework set out above. It also results in the continuation of the current technical issues, but these could obviously be addressed by remedial amendments to the Income Tax Act 2007. Furthermore, there are various specific aspects of the regime (such as the amount of the notional interest deduction) that may have been appropriate when the scheme was first introduced, that now seem inappropriate. As a result, there would need to be good reasons for retaining the current concessionary regime. If it were retained under the proposal set out in Chapter 3, no deductions for the costs of providing the shares should be allowed for the employer (because no income is included for the employee).

- **Modernise the current regime**: This option is inconsistent with the overall tax framework set out above. Amendments could include:
  - the current limit on the amounts employees can pay for their shares could be significantly increased;
  - a minimum level of contribution could be required;
  - schemes could be allowed to be somewhat more flexible in terms of discriminating between full-time and part-time employees, without losing the requirement for schemes to offer benefits which are practically accessible by all employees;
  - an upper limit could be placed on the exempt benefit to employees;
  - the deemed interest deduction could be removed; and
  - the legislation could clearly state whether a loan facility for the full cost of the shares is mandatory.
Submission points

We are interested to hear from readers:

- whether there are good reasons for retaining the current concessionary regime or replacing it with another concessionary regime; and
- if so, whether there are any particular features of the current concessionary regime that should be retained or removed.
CHAPTER 8
Transitional issues

8.1 Employee share schemes are often long-term arrangements, lasting three or more years. Additionally, new share schemes are set up fairly regularly by companies and it is important for companies and employee participants to have clarity around the tax laws when they enter into these arrangements.

8.2 Accordingly, it is important to consider transitional measures for existing and contemplated employee share schemes carefully. It is not desirable to put employers and employees in a position where employees are being granted employee share scheme benefits without certainty as to their tax treatment. However, it would also not be appropriate for employers and employees to be able to unduly extend the application of the existing rules by artificially qualifying for grandparenting grants of employee share scheme benefits which are not, in substance, intended to be conferred until a much later time.

Employee taxation

8.3 Considering the need to meet these objectives we propose that:

• where shares are acquired by an employee and taxed under the existing rules (before the enactment of any new rules), the taxation of that benefit would be dealt with solely under the existing rules (even if under the new rules a subsequent taxing point arises); but

• grandparenting would expire at the end of the third full tax year following enactment. For example, if enactment were to occur in June 2017, grandparenting would expire on 31 March 2021. Any transactions occurring after that date which trigger tax under the new rules would be taxed under the new rules, with an allowance for any tax already paid under the old rules.

Example 9: Transitional rule applies

Paul’s employer issues 1,000 shares worth $1,500 to a trustee on his behalf on 15 October 2016. The shares are issued for no consideration, and so give rise to assessable income to Paul of $1,500. The shares vest in Paul if he remains employed on 15 October 2018. On 30 June 2017, new employee share scheme tax rules are enacted, pursuant to which a similar grant of shares would be taxed only once the employment condition is satisfied, on the value of the shares at that time. The shares duly vest in Paul, and are worth $1,950 on vesting. However, because Paul acquired the shares before the enactment date of the new rules, and the employment condition is satisfied before 31 March 2021, Paul is not taxed when the shares vest in him.
Example 10: Transitional rule does not apply

Peter works for the same employer as Paul, and is issued the same number of shares at the same time, also for no consideration. However, Peter’s shares do not vest unless he is still employed on 15 October 2023. Peter does remain employed, and the shares vest in him on 15 October, 2023, at a time when they are worth $3,000. Peter will be taxed on $3,000 of income, less the $1,500 on which he paid tax in the 2016–17 year.

8.4 If Example 9 is modified so that instead of being given the shares, Paul:

- acquires the shares for $1,500, funded by an interest-free loan from his employer; and
- Paul has the right to sell the shares back to his employer for $1,500 if they do not vest,

there will be no change to the outcome. The taxing point under current law is still the acquisition of the shares, and that occurs before enactment.

Employer taxation

8.5 The employer’s position also needs to be considered. Our proposal for a deduction will not apply to employee share scheme benefits provided which are not taxable because of the grandparenting described above. Transitional rules will also be needed so that an employer is not able to take a deduction under the new rules for granting a benefit where the employer has already claimed a deduction for funding that same benefit under the existing rules. An example is where an employer has taken a deduction for a contribution to a trust for the benefit of employees, and the share benefit is provided by that trust.

Widely offered schemes

8.6 The transitional treatment of the current widely offered concessionary schemes also needs to be considered.

8.7 If it is decided that these schemes should not continue to be available, on what basis should that be done?

8.8 Most obviously, grants made under a concessional scheme:

- before enactment of these proposals would not be affected, and nor would the deemed employer deduction or the FBT treatment of any associated loan; and
- after enactment of these proposals would no longer be entitled to the current exemption, and nor would the associated loans.
8.9 If the concessionary schemes are retained, but the rules are amended, then other transitional approaches may be more appropriate.

**Submission points**

We are interested in readers’ views on this approach to implementation, and whether there are any other issues that need to be taken into account.
CHAPTER 9

Administration, record keeping and reporting

9.1 There are currently no specific reporting requirements for employers offering, or employees participating in, employee share schemes. While employers offering the concessionary schemes discussed in Chapter 7 must apply to the Commissioner initially for approval, there are no on-going reporting requirements with respect to these schemes.

9.2 Similarly, there are no requirements for employers to provide employees with a share scheme statement containing the necessary information to complete their tax return (for example, the market value of their employee share scheme interests). Some employers may voluntarily provide their employees with such a statement.

9.3 The PAYE measures contained in the Taxation (Transformation: First Stage Simplification and Other Measures) Bill require employers to include employees’ employee share scheme 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.

9.4 This 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. This type of information is particularly important to collect in respect of the Commissioner-approved concessionary schemes. This is because it is important for the Government to know how much the tax concession costs and whether it is being appropriately targeted.

9.5 There are a number of measures that could be considered to address these issues. For example, New Zealand could adopt a reporting system similar to Australia’s. This would require employers to provide:

- employees with an employee share scheme statement in the year in which they should be returning income from the share scheme (for example, when no substantial contingencies exist with respect to their interest); and

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27 Employees return the share scheme income in their tax return, but this is not separately identified as such.
Inland Revenue with an annual employee share schemes report listing which employees participated in a particular employee share scheme, what taxable benefits they received during the year and the value of those benefits. The report would need to provide information about any amount the employee had paid for the share scheme benefit to enable the discount to market value to be determined.

9.6 We understand that Australia has seen a significant improvement in compliance as a result of implementing such a reporting regime.

9.7 However, because of the recent changes to the collection of tax on employee share schemes, the Australian approach may not be appropriate for New Zealand. This is because in New Zealand employers will soon be required to include employee share scheme benefits in the EMS for the month in which the benefit is received, even if PAYE is not paid. Because employers are reporting the employee share scheme benefits in (close to) real time, it may make more sense to align more detailed reporting requirements with the monthly EMS filing, rather than requiring employers to provide an annual return.

9.8 Introducing specific employee share scheme reporting requirements involves a trade-off between better compliance and targeting of tax benefits, and increased compliance and administrative costs. It is also important to consider who the compliance costs will fall on.

9.9 Employers will soon be required to generate much of the required information to include their employees’ employee share scheme benefits in the EMS. Under the proposal, employers will also need to collect the information to determine their own deduction.

9.10 Accordingly, it makes the most sense for employers to provide the required information to Inland Revenue and employees. This is generally in line with the reporting requirements in other jurisdictions. It is also generally more efficient for the reporting requirement to fall on the employer (who is managing the employee share scheme for a number of employees), rather than individual employees. Employees are also less likely to be familiar with filing returns and therefore compliance is likely to be lower. However we are interested to hear whether this obligation would impose particularly high compliance costs and whether there are ways these costs could be minimised.

9.11 Another option would be to simply require employers to keep a record of employee share scheme information, which could be requested by Inland Revenue as part of an audit.

9.12 However, one of the aims of the review of the tax treatment of employee share schemes is to move these schemes out of audit and into routine compliance – an actual filing requirement is more likely to achieve this aim.
9.13 We are interested in readers’ views as to whether filing a monthly (real time) or annual employee share schemes report would impose significantly greater compliance costs on employers than simply being required to hold the information. We are also interested in whether readers would support a requirement to provide an employee share scheme statement to participating employees at the time the share scheme benefit is included in the EMS.

9.14 It would also be possible to require employers to register their schemes with Inland Revenue when they are implemented, in a similar way to the current concessionary Commissioner-approved employee share schemes. This, in addition to the reporting described above, would help address the current lack of information on share schemes. However, this measure may impose additional compliance costs on businesses and the other reporting may provide sufficient information for these purposes.

9.15 Whichever approach is adopted, the employee share scheme reporting/record keeping requirements should be implemented in a way that reduces compliance costs as much as possible and potentially capitalises on information already recorded by employers for other purposes (for example, through payroll systems, for financial reporting purposes or for the administration of their employee share schemes generally). The chosen approach should also be consistent with Inland Revenue’s wider Business Transformation framework, both conceptually and in terms of timing of implementation.

**Provisional tax for employees**

9.16 As discussed in the officials’ issues paper *Simplifying the collection of tax on employee share schemes* (April 2015), subjecting employee share scheme benefits to provisional tax can increase compliance costs for employees and potentially result in the imposition of UOMI. With many employers electing to pay PAYE on employee share scheme benefits, the number of employees subject to provisional tax due to the receipt of a share scheme benefit should reduce. However, if employers do not elect to pay PAYE, it is still possible for some employees to fall into provisional tax.

9.17 We are interested in readers’ views as to whether the application of provisional tax to employee share schemes is problematic in practice, or is likely to become so. If so, are there changes that could be made to reduce the practical difficulties associated with provisional tax?
Submission points

We are interested to hear from readers:

- whether they think the current lack of employee share schemes reporting contributes to misunderstanding of tax obligations and non-compliance;
- whether specific employee share schemes reporting (to Inland Revenue and employees) would impose significant compliance costs on employers;
- whether there are ways these compliance costs could be minimised;
- whether monthly (real time) or annual reporting would be preferable;
- whether it would be preferable for employers to simply be required to hold the relevant employee share scheme information, which could be requested by Inland Revenue if required;
- the extent to which the information needed to report on employee share schemes is already held by employers;
- whether registration of employee share schemes with Inland Revenue would impose significant compliance costs;
- whether applying provisional tax to employee share schemes is problematic in practice;
- whether changes could be made to reduce the practical difficulties associated with provisional tax.
APPENDIX 1

Examples of complex employee share schemes

As noted in Chapter 5, problems arise with the application of the current tax rules to complex arrangements such as conditional employee share schemes and option-like arrangements. These include:

- discrepancy between the timing and valuation of employment income generally (for example, salary and wages or cash bonuses) compared with the timing and valuation of employment income from conditional employee share schemes;
- under-taxation of option-like arrangements;
- anomalous taxation of certain schemes that involve price support by way of debt forgiveness or a taxable payment; and
- difficulty in valuing shares with rights which can change, and the inconsistency between the taxation of such shares and the taxation of options.

This appendix provides examples of:

- **Conditional employee share schemes** – where the shares received are subject to future employment conditions. They may be similar in form to unconditional employee share schemes, are economically similar to conditional cash bonuses and should be taxed in the same manner. That is, they are contingent payments that depend upon future employment services and should be taxed when the value, in the form of shares, is received free from further employment conditions.

- **Option-like arrangements** – have terms and conditions and arrangements that may bring forward the taxing point of the share acquisition to a time prior to the earning of the associated employment income and the satisfaction of conditions. If so, they are taxed inconsistently with options, cash bonuses and unconditional employee share schemes, with employment income essentially converted into tax-free capital gains.

- **Shares with contingent rights** – are shares (usually of a special class) with terms and conditions that make them very difficult to value, that only become ordinary shares if certain events occur (such as listing or sale of company). They are similar to options and cash bonuses as they only have value if future events unfold and should be treated in a similar manner.

- **Interest-free share purchase loans repayable out of bonuses** – are loans to employees made to acquire shares that are not repayable until some future date, effectively deferring tax on the discount on the acquisition of a share.

Simple examples of option-like arrangements and conditional ESS were explored in Chapter 5. The following provides more complex examples of such arrangements to illustrate the problems they raise.
Conditional ESS

The tax treatment of schemes where shares are acquired subject to a risk of forfeiture if the employee does not remain in employment for a specified time appears inconsistent with the tax neutrality framework discussed in Chapter 2. In this case, there is no condition dependent upon the future price of the share.

An example of this kind of share scheme is:

- an employee purchases shares in their employer for market value, funded by an interest-free loan provided by the employer;
- the shares are held by a trustee on behalf of the employee, and vest in the employee provided they remain employed for a period;
- on vesting, a bonus is paid to repay the interest-free loan;
- if the employment condition is not met, the employee surrenders their right in the shares in repayment of the loan.

This arrangement results in employees being taxed only if and when the employment condition is satisfied, but on the value of shares when they enter into the share scheme.

The arrangement is a contingent bonus dependent on continued service that is paid in shares. However, unlike an equivalent contingent bonus paid in cash, the employee is taxed on the initial value of the shares, not the value of shares when the bonus is paid. Accordingly, it is likely to result in under-taxation (compared with other equivalent forms of remuneration) if a company’s shares are expected to increase in value (which would be the case if, say, the company does not pay dividends). The employee is (in essence) taxed when they become unconditionally entitled to the shares, but on the initial value of the shares rather than their value when they are received free of conditions. The tax system makes the loan and bonus to purchase the shares artificially attractive compared with an equivalent cash bonus without shares.
Example 1: Share issued for value subject to service-related forfeiture, funded by loan with contingent bonus

Say a company is considering offering some form of share-based remuneration to employees to encourage them to stay with the company and to incentivise performance. The shares are currently worth $100.

The first option being considered is to give the employees, in a year’s time, cash equal to the value of a share in the company at that time, if they are still employed by the company.

The second option is the same as the first, but to give the employees a share in a year’s time instead of cash.

The third option is for an employee to purchase immediately a share for $100 funded by an interest-free loan from the employer. The share is held in a trust until the employee has stayed with the company for 1 year. After this, the share vests and the employee is paid a bonus to repay the loan. If an employee leaves before 1 year is up, the share is returned to the employer and the loan is extinguished.

Under the first and second options (transfer of cash or shares in a year’s time), if an employee remains with the employer for a year, the employee will be taxed in year 2 on the value of the share in year 2. Under the third option, if the employee remains with the company for a year, the employee will be taxed in year 2 on the value of the share in year 1 (the bonus to repay the interest-free loan is taxable, and the balance of that loan will be equivalent to the initial value of the shares).

There is clearly an inconsistent approach to taxing these equivalent remuneration methods, with the third option being preferable if the shares are expected to increase in value.

Of course, it may be the case that, at the time the employment condition is met, the shares are worth less than they were when the employee share scheme was entered into. In this case, the result of the scheme will be more assessable income to the employee than in the case of a simple bonus paid in cash or shares.

However, so long as the employer does not pay dividends, the value of the shares will be expected to increase over time, and the employee share scheme considered above will therefore be expected to produce a lower tax burden than its more simple but pre-tax equivalent alternatives. Furthermore, this kind of employee share scheme raises another fundamental question, as to when employment income is earned.

Example 2: Share gifted subject to service-related forfeiture

Suppose the same facts as the third alternative in Example 1, except that the employer decides to gift the shares to a trustee on behalf of the employee at the outset, with the shares vesting in the employee only if the employee is still with the company in one year. That is, there is no loan or bonus.

The economic benefit of this scheme is identical to the scheme in Example 1. However, in this case the employee will be taxable on $100 in year 1, and this income will be reversed in either year 1 (or year 2) if the employment condition is not met.

The taxation of Example 2 is clearly not consistent with the general approach to taxing income from services, which is that the income is derived once the services for which it is provided are performed. In Example 2, these services are performed only once the year is up. The income should therefore be taxed at that time. If the income
is provided in shares (or any other non-cash form) it should be determined by valuing the shares at that time.

The only difference between Example 2 and the third alternative in Example 1 is the time of derivation of the income. The employee share scheme in Example 1 defers the income to year 2, when the employment condition is met. However, the amount of income is the same as Example 2.

Option-like arrangements

Some employment income can avoid taxation by being converted to capital gains where there is downside price protection on the shares. For example:

- if the retention of the shares by the employee is correlated with share price (perhaps with the purchase of the shares funded by a non-recourse loan or if the employee has the right to put the shares back to the employer for the price the employee paid for them); or
- the shares are retained regardless of their value, but the employee is protected from any fall in their value by loan forgiveness or a payment from the employer.

Share acquired subject to forfeiture purchased with loan from employer

There are a number of employee share schemes which result in non-taxation of employment income. In general, the issue raised is defining the borderline between taxable employment income and tax-free capital gains. Essentially, the schemes involve an upfront purchase of the shares, so that any future gains on the shares will be treated as a capital gain. The result in some employment arrangements is that no tax is payable. However the terms and conditions of the arrangements can mean that they are economically equivalent to a bonus or a share option with employment conditions that would give rise to tax on employment income.

In these schemes, the employee does not need to fund the purchase of the share, as the employer provides the funding through an interest-free loan (as in Example 3 below). The terms of the scheme ensure that the employee will not be out of pocket if the share declines in value. The commercial outcome is equivalent to a bonus or an employee option, in that the employee will only retain the share if it increases in value.

However, under current law, there may be no taxable income to the employee. The benefit derived from the increase in the value of the share is treated as a capital gain. This is inconsistent with the taxation of similar remuneration (such as an employee option or a contingent cash bonus). As the price increase is what gives value to the arrangement and is integral to the employment contract, it is appropriately taxed as employment income. This is demonstrated in Example 3.

28 If the share declines in value, whether or not there is debt forgiveness income depends on how the scheme is drafted and structured. This example assumes there is no debt forgiveness income, but that is not critical to the conclusion. A case where debt forgiveness income arises is discussed below.

29 The analysis of the tax consequences of all the examples assumes that section BG 1 does not apply.
Example 3: Share issued for value funded by loan from employer

As in the examples in the body of the paper, the company's shares are currently worth $100 each and will be worth $150 or $50 with equal probability in a year’s time.

Assume that the employee purchases the shares for $100 in year 1, but this purchase is funded by an interest-free loan from the company. This is treated as a share purchase. Because the employee pays market value for the shares, there is no taxable income. If the shares increase in value, the employee retains the shares and repays the loan, leaving them with a $50 benefit which is treated as a capital gain under current law, and so is tax-free. But if the shares are worth $50, the employee must forfeit the shares in exchange for $100 and use the $100 to repay the loan.

When the shares are worth $150 the employee is effectively paid $50, but is not taxed. Alternatively, the company could offer to pay a cash bonus of $50 if the share value is $150, or could provide the employee with an option with a strike price of $100. These three packages are economically equivalent, but the first package is tax-free, whereas the second and third packages are currently taxed in the same way – if the share is worth $150 in a year’s time, the reward to the employee of $50 is taxed as employment income at that time.

This is illustrated as follows:

<table>
<thead>
<tr>
<th>Remuneration type</th>
<th>Benefit if shares worth $50</th>
<th>Benefit if shares worth $150</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share option</td>
<td>$0 ($0 after-tax)</td>
<td>$50 ($33.50 after-tax)</td>
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<tr>
<td>Contingent bonus</td>
<td>$0 ($0 after-tax)</td>
<td>$50 ($33.50 after-tax)</td>
</tr>
<tr>
<td>Employee share scheme with</td>
<td>$0 ($0 after-tax)</td>
<td>$50 ($50 after-tax)</td>
</tr>
<tr>
<td>forfeiture</td>
<td></td>
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</tr>
</tbody>
</table>

Retention of share with downside protection on loan repayment

A possible variation on Example 3, is an employee share scheme which omits the requirement to transfer the share in satisfaction of the loan if it falls in value, and instead allows the employee to retain the share. Downside protection in this case could be provided by limiting the employer’s right to repayment of the loan to the value of the share at the time of repayment.

30 The interest-free loan will be exempt from FBT provided it meets certain criteria. The reason for the FBT exemption for employee share loans is discussed in Appendix 2.
31 Assuming a 33% tax rate.
32 Assuming a 33% tax rate.
Example 4: Share issued for value funded by loan from employer, with repayment obligation limited to the value of the share

The facts are the same as in Example 3 except that the employee has no right or obligation to sell the share, but their liability to repay the loan is limited to the value of the share at the time repayment is due. On a pre-tax basis, this arrangement is economically equivalent to Example 3. If the shares go up in value to $150, the employee has a $50 benefit. If the shares go down in value, there is no benefit (the employee has in effect paid $50 for a share worth $50).

However, the current tax treatment differs from Example 3. As in the previous example, because the employee pays market value for the share, there is no taxable income upfront. If the share increases in value, the employee retains the share and repays the full $100 loan, leaving them with a $50 benefit tax-free. However, if the shares are worth $50, the employee keeps the share and is only required to repay $50 of the loan. This results in $50 of income to the employee under the base price adjustment (so called, “debt forgiveness income”). There may well be no corresponding deduction to the employer.

The alternative pre-tax equivalent transactions, and their tax treatment, are as described in Example 3.

This is illustrated as follows:

<table>
<thead>
<tr>
<th>Remuneration type</th>
<th>Benefit if shares worth $50</th>
<th>Benefit if shares worth $150</th>
</tr>
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<tbody>
<tr>
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</tr>
<tr>
<td>Contingent bonus</td>
<td>$0 ($0 after-tax)</td>
<td>$50 ($33.50 after-tax)</td>
</tr>
<tr>
<td>Example 3 – share scheme with forfeiture</td>
<td>$0 ($0 after-tax)</td>
<td>$50 ($50 after-tax)</td>
</tr>
<tr>
<td>Example 4 - share scheme with partial debt remission</td>
<td>$0 ($-16.50 after-tax)</td>
<td>$50 ($50 after-tax)</td>
</tr>
</tbody>
</table>

In this case, there is no difference from Example 3 in pre-tax economic outcome. However, taxation outcomes would be different under current law. When the share price rises, the employee would get a $50 benefit without paying tax. When the share price falls, there would be an inclusion in taxable income equal to the amount of the loan that is forgiven or otherwise offset (in the example, $50). The unrealised loss of $50 on the shares would not be recognised. Accordingly, if the price falls, tax would be paid, while no tax would be due when the price rises.

In Example 4, the correct amount of tax is paid, but in the wrong circumstance. That is to say, if the shares decline in value, the employee has no economic return, but has $50 of debt remission income. If the shares go up in value, there is no taxable income, even though the employee is better off. This reflects the fact that under current law while the debt is effectively on revenue account for the employee, the shares are on capital account.

This would appear to be inappropriate. The arrangement is equivalent to a call option or a conditional cash bonus and should be taxed in an equivalent manner as a matter of principle.

Merely taxing the downside protection could also result in significant under-taxation with different economic assumptions involving the time value of money. Consider a different situation. Share prices in period 2 can be either $100 or $120 with equal probability, and the discount rate is 10%. In that case the arrangement would have expected income of $10 (= 50% x [120 – 100]) that should be subject to tax. But in this case, there would be no debt forgiveness income. In the low price world the share is worth $100 which is sufficient to pay off the loan. The arrangement would be
under-taxed. Focussing on the debt forgiveness income ignores the substance of the transaction and concentrates too much on its form.

**Employee share schemes with bonus**

Example 5 adds a bonus to Example 3 to provide a more significant benefit to the employee. The underlying issues are the same as in the previous examples. Some of the benefit received by the employee from the arrangement escapes taxation.

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**Example 5: Share issued for value subject to price-related forfeiture, with non-recourse loan and contingent bonus**

Suppose the company in Example 1 instead wishes to provide the employee with the entire value of a share, rather than just the $50 increase, if the share value in one year is $150. The company could pay a cash bonus in one year of $150 if the share value is $150, or could provide the employees with the share in one year’s time only if the share price is $150. These packages are economically equivalent, and are currently taxed in the same way. If the share is worth $150 in a year’s time, the reward of $150 is taxed at that time. If it is worth less, there is no income.

However, the company could also use an employee share scheme with an immediate issue of shares subject to a risk of forfeiture if the price drops, funded by an interest-free loan, repayment of which is funded by either the return of the shares or a contingent bonus of $100. The employee purchases shares at the outset for $100 funded by the loan from the employer. Because the employee pays market value for the shares, there is no taxable income. If the shares increase in value, the employee retains the shares, receives the bonus and repays the loan. The employee then has a share worth $150 but only $100\(^{33}\) of taxable income. If the shares are worth $50, the employee has the right to repay the loan by returning the shares (and receive no bonus).

The table below compares the outcomes under the three scenarios discussed in this example.

<table>
<thead>
<tr>
<th>Remuneration type</th>
<th>Benefit if shares worth $50</th>
<th>Benefit if shares worth $150</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent bonus</td>
<td>$0 ($0 after-tax)</td>
<td>$150 ($100 after-tax)(^{34})</td>
</tr>
<tr>
<td>Contingent gift of share</td>
<td>$0 ($0 after-tax)</td>
<td>$150 ($100 after-tax)</td>
</tr>
<tr>
<td>Employee share scheme with loan and contingent bonus</td>
<td>$0 ($0 after-tax)</td>
<td>$150 ($117 after-tax)</td>
</tr>
</tbody>
</table>

**Shares with contingent rights**

A different problem is presented by the current tax treatment of share schemes that use shares with contingent rights. An example is “flowering” shares, when employees are given shares with initially very limited rights (usually of special class with no voting or dividend rights). On specified future and uncertain events occurring (such as the company being sold to a third party for a certain value, or listed), the shares convert into ordinary shares.

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\(^{33}\) Many share schemes using loan and bonus arrangements gross-up the bonuses for tax to ensure employees do not have to fund any of the loan repayments themselves. However, because the purpose of this example is to compare equivalent pre-tax benefits, the example assumes no gross-up. This means on an after-tax basis, the repayment of the $100 loan is funded by the $67 after-PAYE bonus plus $33 of the employee’s own money.

\(^{34}\) Assuming a 33% tax rate.
Under current law, the shares are taxable at the time of issue. As with share option plans, taxation at the time of issue will give an appropriate outcome provided the price of the share is set appropriately (based on the chance the company will be sold or listed, and the value of the ordinary shares were that to occur). However, this valuation exercise is extremely difficult. The probability of the company being sold, and the value of the shares at sale, is impossible to estimate with any level of accuracy.

Due to these valuation difficulties, it is hard to determine whether such shares are being appropriately taxed at present. It is also clear that as a black letter law matter, such shares provide a similar outcome to options without giving rise to tax when the “option” is “exercised” (that is, the conversion occurs).

Another way of viewing schemes that provide shares with contingent rights is as a contingent cash bonus. A flowering share plan of the type described above is very similar to a bonus (paid in shares) triggered on the sale of the company to a third party. The initial provision of the shares with limited rights is really a promise to deliver the much more valuable ordinary shares upon the sale of the company; in the same way that an employer would promise at the outset to pay a cash bonus to employees if the company was successfully sold.

A contingent bonus would be taxed when (and if) it is paid – not when the prospect of the bonus is offered. This suggests it would be sensible to align the tax treatment of employee share schemes that provide flowering shares with contingent bonuses.

**Loans repayable out of bonuses**

The use of loans and bonuses by some employee share schemes creates the possibility of an inappropriate deferral of income in the absence of a contingency.

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**Example 6: Deferral of loan repayment and bonus**

In this example, the employee purchases shares for their market value of $100 funded by an interest-free loan from the employer. The loan is repayable in the future, but the employer will provide a bonus to fund the repayment. Because the employee pays market value for the shares, there is no taxable income at that time and because the loan is taken to purchase shares, no FBT is payable on the interest-free loan.

The cashflow under this arrangement is similar to the cashflow for an employee share purchase at a full discount, in that the employee is not out of pocket for the purchase of the shares. Ordinarily a share purchase at full discount would give rise to tax on $100 in period 1.

Subject to anti-avoidance law, this structure might defer the income from the scheme until the bonus is paid to enable repayment of the loan. This could be deferred until the shares are sold or the employee leaves the company. However, the employee has the shares free of any further substantive conditions in period 1.

One option to address this would be a specific anti-avoidance rule to target this type of deferral. For example, a loan which is always repaid out of a bonus could sensibly be disregarded for tax purposes.
APPENDIX 2

Fringe benefit tax and employee share loans

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 (see section CX 35 of the Income Tax Act 2007).

This naturally raises the possibility that one way to correct the problems identified with some employee share schemes would be for FBT to be applied to the interest-free loans associated with an employee share scheme. However, as outlined below, the current FBT treatment is not the source of the problems, and so applying FBT to the benefit of the interest-free loan does not address the underlying issues which are the timing of taxation and the character of income.

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 (the “grossed-up transaction”).

The reason interest-free employee share scheme loans are exempt from FBT, whereas other interest-free employer loans are not, is that in the case of a share scheme loan, the interest on the grossed-up loan would be deductible as there is the necessary nexus with income (that is, the dividends on the shares). This is the reason one of the criteria for the FBT exemption for employee share scheme loans is that the shares must maintain a dividend-paying policy. In the case of other employer interest-free loans, the money may be spent on non-deductible expenditure – for example, to buy a home. Therefore, it is not appropriate to exempt employer interest-free loans from FBT more generally.

The following example illustrates this point.

An employer is prepared to give an employee an interest-free loan of $1,000 to buy the employer’s shares. Suppose that the market rate of interest is 5%. The employer can either:

- lend the employee $1,000, charge interest of $50, but also pay the employee $50 extra salary to meet the interest cost; or
- lend the employee $1,000 interest-free (forgoing $50 of interest income).

Neither the employer nor the employee has any preference between these two options. Pre-tax, the two options are obviously neutral – neither party ends up with any more or less cash.

The outcome is the same once tax is taken into account. In the first case, the employee receives $50 of assessable income, but has a deduction for $50 of interest (as the loan is used to purchase dividend-generating shares). Similarly, the employer is entitled to a $50 deduction for the salary payments, but also derives $50 of assessable interest income. Accordingly, there is no tax payable as a result of this arrangement.
If FBT was charged in the second case, employers and employees would simply adopt the counterfactual transaction – charging interest on their employee share scheme loans, but funding it with an equivalent salary payment. It is inefficient for tax to drive the commercial arrangements between the parties. To ensure tax neutrality between the two economically equivalent transactions described above, it is necessary to exempt the interest-free loan from FBT.