

July 2016

A special report from
Policy and Strategy, Inland Revenue

Simplifying the collection of tax on employee share schemes

Sections CE 2, RD 6, RD 7, RD 7B, of the Income Tax Act 2007; section 46(6B) of the Tax Administration Act 1994; section 4 of the KiwiSaver Act 2006; sections 11 and 15 of the Accident Compensation Act 2001

This special report provides early information on changes to the tax rules affecting the collection of tax on benefits an employee receives from an employee share scheme. Benefits provided to an employee under a share purchase agreement are “employment income” for income tax purposes.

The Income Tax Act 2007 and Tax Administration Act 1994 have been amended by integrating employment income in the form of employee share benefits into the PAYE (pay as you earn) system. The changes were introduced in the Taxation (Transformation: First Phase Simplification and Other Measures) Bill enacted on 2 June 2016. Information in this special report precedes full coverage of the new legislation that will be published in the August edition of the *Tax Information Bulletin*.

Employers are now responsible for reporting share benefits under an employee share scheme.

Employers have a choice about whether tax is withheld on such benefits.

The changes are designed to remove problems facing some employees with meeting their tax obligations in relation to these benefits, and improve the integrity of the tax system by reporting income information at its source.

Key features

The general PAYE collection rules in the Income Tax Act and disclosure rules in the Tax Administration Act have been changed to:

- allow employers to choose to use the PAYE system and withhold tax on any employment income an employee receives under a share purchase agreement using the PAYE system; and
- require employers to report the value of any benefits an employee receives under a share purchase agreement via the employer monthly schedule (EMS).

Consequential changes have also been made to the Accident Compensation Act 2001 and the KiwiSaver Act 2006 to ensure that share benefits are not counted as employment income under these Acts.

Background

Benefits an employee receives under a share purchase agreement are treated as employment income under the Income Tax Act 2007.

Under the old rules, unlike most employment income or benefits (such as salary and wages or the use of a company car), such share benefits were not subject to tax at source under either the PAYE or FBT rules. This meant employee recipients of a benefit under a share purchase agreement had to file an individual tax return including the benefit as income and pay the tax on those benefits themselves.

For employees unused to filing returns and paying tax directly to Inland Revenue, these obligations were not always well understood and imposed compliance costs. These compliance costs could affect voluntary compliance and perceptions about the integrity of the tax system.

From Inland Revenue's perspective, the rules imposed a number of administrative costs. If an individual employee did not return the income from an employee share scheme, the Commissioner had to expend resources to collect a potentially small amount of tax from an individual.

In April 2015, officials released an issues paper, *Simplifying the collection of tax on employee share schemes*, which discussed the problems with the collection of tax on benefits received under an employee share scheme. The issues paper discussed changing the collection of tax on employment income received under a share purchase agreement using the PAYE system, the FBT rules or a separate withholding tax.

Inland Revenue considered a number of ways information about employee share benefits could be collected under the PAYE system and concluded that the employer monthly schedule (EMS) was the best option as the necessary information is captured in a timely and administratively efficient manner.

Application date

The new rules apply to income years beginning on or after 1 April 2017. Validation rules apply if employers have withheld and paid tax in a return of income in earlier income years.

Benefits treated as income under section CE 2 and received on or before 31 March 2017 should be returned by the employee.

Detailed analysis

The basic rule: what employee share benefits are covered by the new rules?

Under the Income Tax Act, employment income from an employee share scheme arises in the specific circumstances set out in section CE 2. Table 1 illustrates the responsibilities under the tax Acts for employers and employers to report and pay tax on income from an employee share scheme from 1 April 2017.

Table 1: When income arises from an employee share scheme and compliance obligations on the employer and employee

When income arises	Pre 1 April 2017	Post 1 April 2017
When the employee acquires shares – section CE 2(2)	Employee must report income and pay tax.	<ul style="list-style-type: none"> (i) Employer reports income for current employees. (ii) Employer may choose to withhold tax. (iii) Employee must pay tax if (ii) does not apply. (iv) Former employees must report and pay tax unless (ii) applies.
When employee disposes of rights to acquire shares to non-associates – section CE 2(3)	Employee must report income and pay tax.	Employee must report income and pay tax.
When an associate of the employee acquires shares – section CE 2(4)	Employee must report income and pay tax.	<ul style="list-style-type: none"> (i) Employer reports income for current employees. (ii) Employer may choose to withhold tax. (iii) Employee must pay tax if (ii) does not apply. (iv) Former employees must report and pay tax unless (ii) applies.
When an associate disposes of rights to acquire shares to non-associates – section CE 2(5)	Employee must report income and pay tax.	Employee must report income and pay tax.

The section CE 7 definition of “share purchase agreement”, which applies to income in the form of share benefits under section CE 2, means the employer is responsible for reporting the value of the benefit received under a scheme offered by an associate of the employer if the benefit is in connection with the employee’s employment or service.

The obligation to report the value of a share benefit and the election to withhold PAYE is therefore limited to situations where income arises under section CE 2(2) and CE 2(4) – situations when there is a transfer of shares to the employee or an associate of the employee.

Exceptions to the basic rule

The new reporting and payment rules have two important exclusions from the basic rule.

- **Former employees:** When an employer's PAYE obligations for an employee have ended, as set out in the definition of "employee" in section 46(7) of the Tax Administration Act, any benefits accruing to the employee do not need to be reported by the employer. Consider the examples below:
 - (i) Employee ceases employment from 1 October 2017. A cash bonus is paid to the former employee in March 2018. The employee has their incentive shares vested in November 2017. In this situation, the employer has an obligation to report the value of benefits received by the former employee.
 - (ii) Employee ceases employment from 1 October 2017. A cash bonus is paid to the former employee in March 2018. The employee has their incentive shares vested in April 2018. In this situation, the employer has no obligation to report the value of benefits received by the former employee. The employer can still choose to report and withhold tax on any benefit, however.
- **Commissioner-approved schemes:** Benefits received from an employee share scheme to which sections DC 12 and DC 13 of the Income Tax Act apply, known as "Commissioner-approved schemes", are not required to be reported. Under section CE 2(7) of the Income Tax Act, these benefits are treated as having a nil value.

Disclosing share benefits in the employer monthly schedule

Section CE 2 specifies the income year in which an employee derives a share benefit from an employee share scheme. For most employers, they will be responsible for reporting the value of the share benefit in the relevant employer monthly schedule (EMS) for which the share benefit accrues to the employee. For example, a share benefit that accrues to an employee in August 2017 would be included in the employer's EMS for the period ending 31 August, and due on 20 September 2017.

Special income recognition rule for "large" employers

For employers that have annual withholding obligations under the PAYE system of \$500,000 or more (including employer superannuation contribution tax – ESCT), the disclosure of income from a share benefit has been modified. Under section RD 22(2), employers with this level of withholding are considered to be "large" employers, and new section CE 2(11) shifts the recognition of employment income to the next PAYE payment period. This rule applies whether or not the employer has withheld tax on the share benefit.

Under this new rule, income from the share benefit is shifted to the next PAYE payment period.

The implications for employers of this new rule are as follows:

- Recognition of share benefits that vest to the employee in the first half of the month is shifted to the second half of the same month and reported by the employer in the employer monthly schedule for that month.

- Recognition of share benefits that vest to the employee in the second half of the month is shifted to the first half of the following month and would be reported in the employer monthly schedule for that following month.

This rule does not affect the date that the share benefit should be valued. It does, however, affect when share benefits are reported to Inland Revenue. In some cases, such as when a benefit arises between the 16th and the last day of March, the rule shifts employee income into the next tax year. Inland Revenue may investigate instances where employees seek to exploit for personal advantage the deferred recognition of income for share benefits provided between 16 and 31 March if those share benefits are provided out of pattern with previous years or the decision to acquire shares is out of step with market conditions.

Affected employers should raise the effect of this new timing rule with their employees as it may affect their tax obligations for the income year and any associated social policy obligations and entitlements.

Withholding tax on employee share benefits under the PAYE system

If the employer elects to withhold under new section RD 7B, share benefits received from a share purchase agreement are treated as an “extra pay” for the purposes of section RD 7 of the PAYE rules. Such benefits are treated as a “PAYE income payment” under section RD 3. This ensures that the obligation to pay tax is transferred from the employee to the employer under the PAYE rules. The applicable rate of tax on the benefit will be determined by:

- section RD 10, if the employee has made an election with their employer to fix the rate of tax on extra pays; or
- section RD 17.

For the purposes of section 33A of the Tax Administration Act, the employee is treated as a non-filing taxpayer when the employer returns and pays tax for the employee.

Selling shares to meet PAYE withholding

Employers who sell shares to meet an employee’s tax liability will be acting on the employee’s behalf. The tax treatment of the sale of shares to meet employees’ tax obligations under the PAYE rules should not create a different outcome from the situation if the employee were to sell the shares themselves to meet a tax obligation. If the shares vested in the employee were held on capital account then, in principle, any share disposal to meet tax obligations (independent of whether tax is withheld under PAYE) should not result in those shares being “tainted” and treated as held on revenue account.

Compliance obligations on employees

The overarching purpose of the changes is to reduce the need for employees to complete an IR3 return or request a personal tax summary (PTS). For employees whose employers have elected to withhold PAYE, there should be no further tax to pay on that share benefit income. Employees may still have filing obligations if they have other income.

Employees whose employer has reported only the value of any share benefit will have tax owing and should arrange payment.

Employees who receive employment income from a share benefit by way of selling share rights to another party, or an associate disposes of the share rights, will continue to have obligations to report that income to Inland Revenue.

Former employees will need to be aware that their tax obligations may be affected by their employer's disclosure obligations and whether tax has been withheld on any share benefit that vests in the former employee.

Examples

Table 2 sets out the compliance implications for large and "small" employers in connection with the new rules for current employees.

Table 2: Examples

Facts	When employer reports benefit/pays tax	When treated as derived by employee	Tax outcome
<p>Large employer</p> <ul style="list-style-type: none"> • Share benefit vests in employee on 25 March 2018. • Employer elects to withhold tax under section RD 7B of the Income Tax Act. 	<ul style="list-style-type: none"> • Employer records the benefit in the EMS for April, which is returned on 5 May. • Tax on the benefit is paid in the PAYE payment period due 20 April. 	<ul style="list-style-type: none"> • Employee treats the income as derived in April 2018, the next tax year after the year in which the benefit is vested. 	<ul style="list-style-type: none"> • Share benefit is treated as an extra pay under section RD 7. • Tax is withheld, assuming for the purposes of section RD 6, that the benefit was paid on 1 April on the basis of the value of the share benefit as at 25 March. • Employee has no obligation to separately report the income or pay tax as these have been done by the employer.
<p>Large employer</p> <ul style="list-style-type: none"> • Share benefit vests in employee on 25 March 2018. • Employer chooses not to withhold tax on the benefit. 	<ul style="list-style-type: none"> • Employer records the benefit in the EMS for April, which is due on 5 May. 	<ul style="list-style-type: none"> • Employee treats the income as derived in April 2018, the next tax year after the year in which the benefit is vested. 	<ul style="list-style-type: none"> • Employee has no obligation to report the income separately but will need to pay tax on the value of share benefit.
<p>“Small” employer</p> <ul style="list-style-type: none"> • Share benefit vests in employee on 25 March 2018. • Employer elects to withhold tax under section RD 7B of the Income Tax Act. 	<ul style="list-style-type: none"> • Employer records the benefit in the EMS for March, which is returned on 20 April. • Tax on the benefit is paid in the PAYE payment period due 20 April. 	<ul style="list-style-type: none"> • Employee treats the income as derived in March 2018. 	<ul style="list-style-type: none"> • Share benefit is treated as an extra pay under section RD 7. • Tax is withheld for the purposes of section RD 6 when the benefit was paid on 25 March using the value of the share benefit as at 25 March. • Employee has no obligation to separately report the income or pay tax as these have been done by the employer.
<p>“Small” employer</p> <ul style="list-style-type: none"> • Share benefit vests in employee on 25 March 2018. • Employer chooses not to withhold tax on the benefit. 	<ul style="list-style-type: none"> • Employer records the benefit in the EMS for March, which is due on 20 April. 	<ul style="list-style-type: none"> • Employee treats the income as derived in March 2018. 	<ul style="list-style-type: none"> • Employee has no obligation to separately report the income but will need to pay tax on the value of the share benefit.