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A special report from
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Employee share schemes

Sections CD 25, CD 43, CE 1, CE 2, CE 6, CE 7, CE 7B, CE 7C, CE 7D, CV 20, CW 26B, CW 26C, CW 26D, CW 26E, CW 26F, CW 26G, CZ 1, DV 27, DV 28, EX 38, GB 49B, HC 27 of the Income Tax Act 2007; sections 3(1) and 63B of the Tax Administration Act 1994

This special report provides early information on changes to employee share schemes in the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018, enacted on 29 March 2018, and precedes full coverage of the new legislation in the June 2018 edition of the *Tax Information Bulletin*.

Employee share schemes are arrangements for companies to provide shares and share options to their employees. They 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the tax rules applying to them in New Zealand had not been comprehensively reviewed during that period and were out of date.

Recently a number of problems with these rules emerged, primarily in three areas:

- complex arrangements allow taxable labour income to be converted into tax-free capital gains;
- there is no employer deduction for the provision of employee share scheme benefits in some circumstances; and
- the rules and thresholds relating to tax-exempt widely-offered employee share schemes are outdated and need review.

New core rules

Changes have been made to the core rules for the taxation of employee share schemes following enactment of the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018. The objective of the proposals is neutral tax treatment of employee share scheme benefits. That is, to the extent possible, the tax position of both the employer and the employee should be the same whether remuneration for labour is paid in cash or shares. This will ensure that employee share schemes cannot be structured to reduce the tax payable in respect of these arrangements, as compared to an equivalent cash salary or other more straight-forward employee share schemes.

Generally, these rules will apply to benefits where the taxing point under the previous law has not occurred before 29 September 2018.

This special report covers changes that:

- determine the taxing point for employee share schemes as being when an employee is treated as having earned shares under an employee share scheme, and after which they hold the shares like any other shareholder;
- provide a new deduction rule for employers providing employee share scheme benefits to employees, which aligns the tax treatment of providing employee share scheme benefits with the tax treatment of paying other types of employment income;
- simplify the rules for certain exempt employee share schemes, with a greater level of exempt benefits able to be provided and more flexibility in the design of these schemes; and
- make other consequential and technical amendments.

SCOPE OF THE NEW RULES

Sections CE 1, CE 2, CE 6, CE 7, CE 7B, CE 7C, CE 7D, DV 27

The new income and deduction rules apply to arrangements where employees receive shares as part of their remuneration package. There are a number of qualifications and carve outs to the definition of "employee share scheme" so that the rules are appropriately targeted.

Background

The definition of "employee share scheme" is a key component of the rules.

The core employee share scheme rules in the Income Tax Act 2007 previously applied to "share purchase agreements". These are agreements to dispose of or issue shares to an employee, entered into in connection with the employee's employment or service, whether or not an employment relationship exists when the employee receives a benefit under the agreement.

Under the old rules there was some uncertainty as to whether this definition encompassed arrangements entered into before a person commenced a formal employment relationship and had received a PAYE income payment.

This definition also excluded shareholder-employees to the extent to which they chose not to deduct PAYE.

There is no policy rationale for excluding these classes of recipients of employee share scheme benefits.

Key features

The new rules apply to benefits provided under arrangements that involve issuing or transferring shares to past, present and future employees[1] or shareholder-employees (or their associates) of the issuing company (or a group company). They do not apply to arrangements that involve issuing shares to other goods or service providers.

The new rules do not apply to arrangements that require employees to:

- pay market value for the shares on the "share scheme taxing date" (described in more detail below, but generally the date on which the employee holds the shares like any other shareholder); or
- put at risk shares they acquired for market value, where the scheme provides no protection to the person against a fall in the value of the shares.

They also do not apply to exempt employee share schemes (which have their own specific rules, discussed below).

[1] This includes any person receiving a PAYE income payment. A PAYE income payment includes a schedular payment – that is, a payment subject to withholding because it is of a class set out in Schedule 4 of the Act.

When the new rules do not apply, shares provided in exchange for goods and services will be taxable to the recipient under general principles applying to barter transactions.

Application date

The new rules apply to benefits provided under employee share schemes which are not taxed under the existing rules before 29 September 2018. There are further details on the application date in the section on technical, consequential and transitional matters.

Detailed analysis

Under sections CE 1(1)(d), CE 2, and CE 6 – 7D, a benefit received under an **employee share scheme** is income of a person. Section DV 27 governs the corresponding deductions available to the employer offering the employee share scheme.

"Employee share scheme" is defined in section CE 7 as an *arrangement* with a purpose or effect of issuing or transferring shares in a company to a person who *will be, is, or has been* an employee (or *shareholder-employee*) of that company or of another company in the same group, if that arrangement is connected to the person's employment or service.

It also includes the provision of shares to an associate of the employee or shareholder-employee (for example, a family trust), if the arrangement is connected with the employee's employment or service.

The use of the term "arrangement" covers all aspects of a scheme, for example, direct transfers of shares, loans to buy shares, bonuses, put and call options, and transfers to trusts, etc. The definition also covers past, present and future employees, and includes shareholder-employees.

However, an employee share scheme does not include an arrangement that requires an employee, shareholder-employee, or associate to:

- pay market value for the shares on the "share scheme taxing date" (described in more detail below, but generally the date on which the employee holds the shares like any other shareholder); or
- put at risk shares they acquired for market value where the scheme provides no protection to the person against a fall in the value of the shares. This exception does not apply if the person acquired the shares using funds which were required to be used for the acquisition.

Example 1

Jim is employed by ABC Co, a closely-held company. As part of his employment agreement, after he has worked for the company for three years, if the company's other shareholders are happy with his performance, they will let him buy twenty five percent of the company's shares for their current market value at that time.

While this is an arrangement with a purpose or effect of issuing or transferring shares in a company to a person who will be, is, or has been an employee (or shareholder-employee), market value will be paid for the shares on the share scheme taxing date. Accordingly, this arrangement is **not** an employee share scheme for the purposes of the proposed new definition.

Example 2

Casey, Hamish and Steve get together and incorporate a company to develop some technology-related intellectual property (IP). They are each employed by the company. When the shares are issued they are worth virtually nothing (on a balance sheet basis) and a nominal subscription price of $0.01 is paid by each shareholder-employee. The shareholders' agreement states that to ensure they commit to developing the IP over three years, if they leave within three years they forfeit their shares.

While this is an arrangement with a purpose or effect of issuing or transferring shares in a company to a person who will be, is, or has been an employee (or shareholder-employee), market value was paid for the shares, not using money provided to the employees for that purpose, and the employees have then chosen to put the shares at risk. Accordingly, this arrangement is **not** an employee share scheme for the purposes of the proposed new definition.

Example 3

Melissa is hired as CEO by X Co, a closely-held company with exciting but uncertain prospects. She is paid a $120,000 per annum salary. Because she is an employee, she is also able to buy $50,000 worth of shares (which is the current market value – established by an independent valuation). If Melissa leaves employment within three years, X Co has the right to buy her shares back for the lesser of $50,000 and market value. After that date, it has the right to buy the shares back for full market value.

This is because X Co does not want Melissa to hold its shares if she is not part of their team, but after three years they are prepared for Melissa to receive the upside in the shares. Before then, she bears the risk of loss but no chance of gain. If the shares fall to $10,000 and Melissa leaves X Co within three years, the company will buy her shares back for $10,000 and she will lose $40,000 of her $50,000 investment.

If Melissa leaves the company within three years and the shares are worth $1 million, then the company will buy them back for $50,000 and Melissa will be denied the upside.

This arrangement is **not** an employee share scheme as defined as Melissa has paid market value for her shares not using consideration provide to her for this purpose, and has then effectively put them at risk for three years.

If X Co paid Melissa a signing bonus of $74,627 on the basis that the after tax amount of $50,000 would be used to acquire the shares, the arrangement **would** be an employee share scheme – see in particular section CE 7(b)(iii).

Example 4

Think Big Ltd is an engineering consultancy firm, in which the principal employees are also shareholders and directors.

New principals are required to subscribe for shares pro rata with existing principals. The price is:

3 × the average of previous three year's earnings ÷ number of principals

The shares must be sold back to the company when the principal ceases employment. The same formula is used to determine the amount payable to a principal when they leave the company. However, if the principal leaves to go to another engineering consultancy in New Zealand, the principal gets back no more than the amount subscribed for their shares. Think Big Ltd has received advice that the formula is a reasonable approximation of how a third party purchaser would value the firm.

The company is prepared to lend the share subscription amount to new principals. Over the following five years a portion of the dividends payable by the principal on their shares must be used to repay the loan. If the principal leaves the firm before the loan is repaid, they still have to repay the loan in full.

In order to be an employee share scheme as defined in section CE 7, the arrangement must come within one of the limbs of paragraph (a) and not be excluded by any of the limbs of paragraph (b).

The arrangement has a purpose of transferring shares in Think Big Ltd to the new principal, who is either an employee or a shareholder-employee (as defined) of the company. The arrangement is connected with the new principal's employment or service. It therefore satisfies paragraph (a)(i) or (a)(ii).

The arrangement is not an exempt employee share scheme, so is not excluded by paragraph (b)(i).

If the three times average earnings formula is a reasonable way to determine market value consideration, the arrangement might be excluded from being an employee share scheme by paragraph (b)(ii) of the definition. However, because this amount is not payable if the employee leaves to go to a competitor, paragraph (ii) is not in fact satisfied.

Neither is paragraph (b)(iii) satisfied. Assuming the amount paid for the shares is their market value:

- The arrangement does require the person to put the shares at risk, because if the amount in the formula declines, the person will get less on the sale of their shares than they paid.
- However, the consideration for the shares is provided by the company by way of a loan, on the basis that it is used for acquiring the shares.

If a new principal uses their own funds to acquire the shares, paragraph (b)(iii) would be satisfied.

The definition of employee share scheme also excludes exempt schemes (which have their own specific rules, discussed below).

TIMING AND AMOUNT OF EMPLOYEE'S INCOME

Sections CE 1, CE 2, CE 6, CE 7, CE 7B, CE 7C, CE 7D, DV 27

The amendments ensure that the timing and amount of an employee's income from an employee share scheme is consistent with other forms of employment income.

Background

Any reward for services is generally taxable as income, under the ordinary definition. However, the application of the common law of income tax to the provision of rewards in the form of property, for example shares or options, has sometimes been problematic.

For that reason, since 1968, New Zealand tax law has contained special provisions relating to the taxation of employee share scheme benefits.

Under the previous law, shares provided under an employee share scheme were taxable when the employee acquired the shares. The previous section CE 6(2) provided that:

- shares acquired pursuant to an option were treated as acquired when the option was exercised. This meant that an employee was not taxed on the grant or vesting of an option, but on its exercise; and
- shares acquired by a trustee for the benefit of an employee (that is, a specific employee) were treated as acquired by the employee, even if the employee might be required to forfeit the shares.

The second of these rules led to outcomes that were neither tax-neutral nor consistent with the taxation of employee share options.

Examples 5, 6, 7 and 8 reflect the previous rules.

Example 5

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 (if he satisfies the condition) $1,000 of taxable income.

If instead his employer decides to pay Jim the same bonus in shares, the tax neutral outcome would be for the employer to provide $1,000 of shares, and for Jim to pay $330 tax.

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.

Example 6

Suppose that Jim's employer offers him a cash bonus if he is still working for the employer in a year's time. The amount of the bonus is the value of 1,000 shares in one year's time. Suppose that 1,000 shares are worth $1,000 at the start of the year, when the offer is made, and $1,500 at the end of the year. Jim will not be taxed on $1,000. He will be taxed on $1,500 when he receives the cash bonus.

Instead of offering a cash bonus dependent on the value of the shares, suppose Jim's employer transfers 1,000 shares to a trustee, on the basis that the trustee will transfer them to Jim at the end of the year if he is still with the company, and not otherwise. The economic benefit to Jim is the same as in the first variation of this example. However, under prior law, Jim had income of $1,000 when the shares were transferred to the trustee. This was not consistent with the treatment of equivalent cash remuneration (that is, the first variation of this example), and therefore was not a neutral tax treatment.

Example 7

Jane's employer decides to provide her with options to buy 1,000 shares in the company. The shares are currently worth $1, and the options have a strike price of $1 (that is, they are issued "at the money"). The options can be exercised only if Jane is still employed in a year. Suppose there is an equal chance that the shares will be worth $600 or $1,600 in a year's time. If they are worth $1,600, Jane exercises the options, and has $600 of taxable income. If they are worth $600, she does not exercise the options, and gets nothing.

Example 8

Instead of providing options, suppose Jane's employer sells her 1,000 shares for $1,000, and provides her with an interest-free loan to fund the purchase. The loan must be repaid after one year. The employer specifies that if the shares have fallen in value at the repayment date, Jane must sell the shares back to the employer for $1,000. Suppose the same share values and probabilities as in example 3. If the shares are worth $1,600 in one year, Jane will keep the shares and pay off the loan. If they are worth $600, she will sell them to the employer for $1,000 and use that money to pay off the loan.

Under prior law, Jane had no taxable income from this arrangement, even though it produced outcomes identical with the option arrangement, under which Jane has $600 of income if she acquires the shares.

The new rules prevent these inconsistent outcomes by deferring the time at which an employee recognises income from an employee share scheme in certain situations. In examples 2 and 5, under the new rules, both Jim and Jane will be taxed on the value of the shares once the employment condition is satisfied (in Jim's case) or the employer's right to acquire the shares for $1,000 no longer exists (in Jane's case).

Key features

Section CE 7B provides that benefits provided under an employee share scheme (usually in the form of shares) are assessable income for an employee at the earlier of the date when:

- the benefits are either transferred or cancelled; or
- the employee share scheme beneficiary owns the shares in the same way as any other shareholder. They will not own the shares in the same way as any other shareholder if (for example) the employee is required to forfeit the shares if they choose to leave the

company, or the employee is entitled to be compensated for a decline in the value of the shares.

This time is referred to as the "share scheme taxing date". There is no change to the share scheme taxing date for straight-forward employee share options, which already reflects this principle, in that the employee is not taxed until the option is exercised.

The amount of the benefit is the amount received for the transfer or cancellation, or the value of the shares at the share scheme taxing date. It is reduced by the amount paid (if any) for the benefit.

The new rules require matching between the employee's income and the employer's deduction, so the rules outlined above also determine the amount and time of the deduction to the employer (the employer's deduction is discussed further below).

Application date

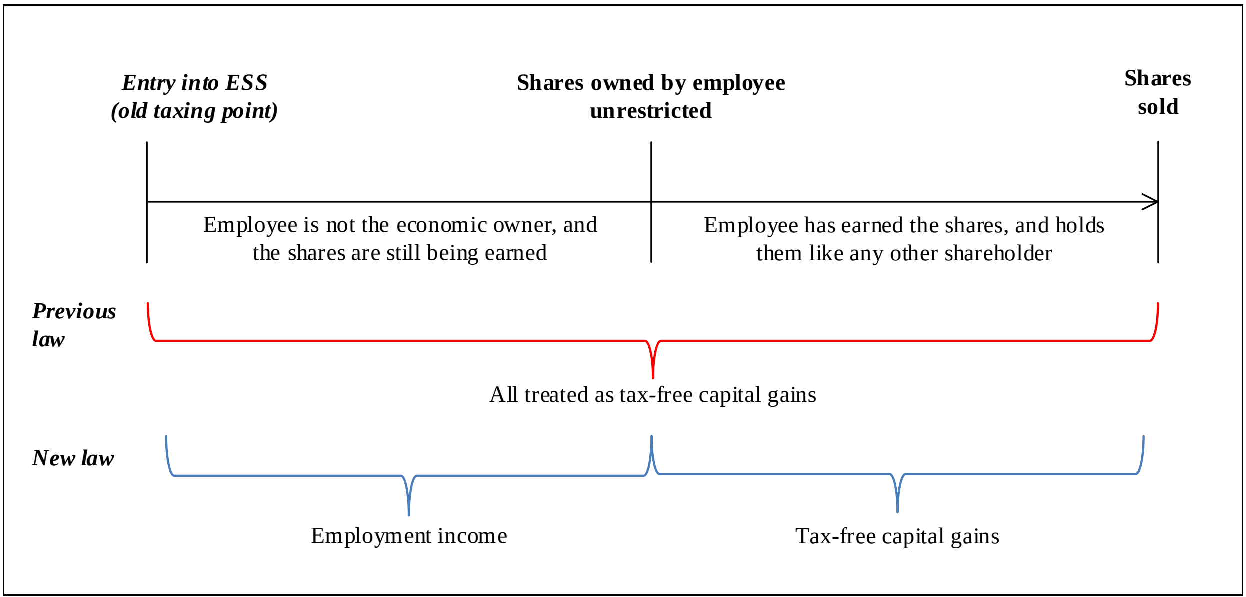
The new share scheme taxing date and rules for calculating employee share scheme income will apply to benefits provided under employee share schemes which are not taxed under the existing rules on or before 29 September 2018. There is further detail on the transitional arrangements below.

Timing of income

The time when the employee is taxable is defined as the "share scheme taxing date", and is defined in section CE 7B.

Unless a share scheme beneficiary first transfers their share scheme benefits to a non-associate, or the company cancels them, the share scheme taxing date is when:

- there is no material risk that beneficial ownership of the shares will change, or that the shares will be required to be transferred or cancelled;
- the employee is not entitled to be compensated for a fall in the value of the shares; and
- there is no material risk that there will be a change in the terms of the shares affecting their value.



If the benefits are cancelled or transferred to a non-associate before these events occur, then the share scheme taxing date is at the time of the cancellation or transfer.

In determining whether there is a risk of a change of ownership, transfer or cancellation, certain rights and requirements do not affect the employee's status as the economic owner of the shares under the scheme (section CE 7B(2)) and are ignored. They are rights or requirements:

- for transfer for market value;
- not contemplated by the employee share scheme;
- that have no material risk of occurring;
- that are of no material commercial significance; or
- that also apply to shares not subject to the employee share scheme.

The following series of examples illustrate how the new rules will work in practice for common types of employee share schemes.

Example 9: Simple vesting period

Facts

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

Result

The share scheme taxing date is when the three years is up and the employee is still employed.

Analysis

The risk of loss of the shares for the first three years means there is a material risk that the beneficial ownership of the share will change under the terms of the scheme. None of the exceptions apply.

Example 10: Vesting period with good leaver exception

Facts

A Co transfers shares worth $10,000 to a trustee on trust for an employee. If the employee leaves the company for any reason during the next three years, the shares are forfeited for no consideration. However, if the employee ceases employment because of death, illness, disability, redundancy or retirement within the three-year period they are entitled to the shares. After three years, the shares are transferred to the employee.

Result

The share scheme taxing date will be the end of the three-year period if the person is still employed, or when the person leaves for any of the above reasons.

Analysis

There is a material risk that the employee will leave employment for some other reason than those listed (for example, a better opportunity presents itself). The share scheme taxing date does not occur so long as that risk exists, because it means that there is a material risk that the beneficial ownership of the shares may change under the terms of the scheme.

Example 11: Vesting subject to misconduct

Facts

A Co transfers shares worth $10,000 to a trustee on trust for an employee. The shares are transferred to the employee if they are still employed by the company after three years. Also, if the employee ceases employment for any reason other than being subject to disciplinary action or committing some form of employment-related misconduct during the three-year period (that is, being a "bad leaver") the employee is entitled to the shares at that time.

Result

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

Analysis

The risk of the employee losing their job for these "bad" reasons during the three year period, and thus losing entitlement to the shares, is not sufficiently material to require deferral.

Example 12: Vesting subject to misconduct with accrual

Facts

A Co transfers shares worth $10,000 to a trustee on trust for an employee. If the employee is still employed by the company after three years, the shares will be transferred to the employee. If the employee ceases employment for any reason other than being subject to disciplinary action or committing some form of employment-related misconduct during the three-year period (that is, being a "bad leaver") the employee is entitled to a pro rata portion of the shares based on completed years' service (for example, nothing for the first year, one third of the shares if the employee leaves between one and two years, etc.).

Result

There will be three share scheme taxing dates – at the end of years one, two and three respectively. The employee will be taxed at the end of each year on the value at that time of one third of the shares.

Analysis

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

Example 13: Complex vesting

Facts

A Co transfers shares worth $10,000 to a trustee on trust for an employee. If the employee ceases employment during the next three years due to being subject to disciplinary action or committing some form of employment related misconduct, the employee forfeits all shares.

If the employee ceases employment during the next three years due to death, illness, disability, redundancy or retirement, all shares are transferred to the employee.

If the employee ceases employment during the next three years for any other reason, a pro rata portion of the shares is transferred to the employee, equal to the number of complete months since the transfer divided by 36 (months).

After three years if the employee is still employed, all the shares are transferred to the employee.

Result

The employee has income at the end of each month equal to the value at that time of the additional number of shares to which the employee is entitled if the employee leaves "for any other reason".

Analysis

The risk of the employee leaving voluntarily for another job is sufficiently high to be material. The risk of the employee leaving as a bad leaver is not. Accordingly the share scheme taxing date arises as the employee becomes entitled to retain the shares if she leaves the company other than as a bad leaver.

Example 14: Performance hurdles

Facts

A Co transfers shares worth $10,000 to a trustee on trust for an employee. The employee is not entitled to the shares unless a total shareholder return[2] hurdle (measured as an annual percentage) is also met. If the hurdle is met in year one, one third of the shares vest. If it is met in year two, a further one third of the shares vest. Also, if it was not met in year one, but is met on a combined basis over years one and two, a further one-third of the shares will vest. The same approach applies in year three.

No shares vest once the employee leaves the company. Vested shares are not transferred to the employee, but held by the trustee until the three years is up. If the employee leaves during that period for any reason other than being a bad leaver, the vested shares will be transferred to the employee.

Result

There will be three possible share scheme taxing dates – at the end of years one, two and three respectively. The employee will be taxed at the end of each year on the value of the shares that vest at that time.

Analysis

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

Example 15: Vesting period, with compulsory sale for market value thereafter

Facts

A Co transfers shares worth $10,000 to a trustee on trust for an employee. If the employee leaves the company for any reason during the next three years, the shares are forfeited for no consideration. After three years, the trustee retains legal ownership of the shares, and the employee must transfer their rights back to the trustee or A Co when the employee leaves. However, once the three-year period is up, the employee will receive the market value of the shares when their beneficial ownership is transferred.

Result

The share scheme taxing date is when the three years is up and the employee is still employed.

Analysis

Once the three-year period has expired, the employer's or trustee's right to acquire the beneficial interest in the shares is for market value, and is therefore not taken into account in determining the share scheme taxing date (section CE 7B(2)(a)).

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

Example 16: Insubstantial put option

Facts

A Co transfers shares worth $10,000 to a trustee on trust for an employee. The shares will be transferred to the employee if she is still employed in three years' time. Also, if the employee ceases employment during that time for any reason other than being subject to disciplinary action or committing some form of employment-related misconduct during the three-year period (that is, being a "bad leaver") the employee is entitled to the shares.

Until the shares are transferred, the employee has the right to sell its beneficial interest in the shares back to the trustee for a total price of $1.

Result

The share scheme taxing date would be when the shares are provided to the trustee.

Analysis

The employee's right to sell the shares for $1 is not, at the time it is granted, a right which has a material risk of being exercised, given that there is no liability attached to the shares and that they are then worth $10,000. This right would therefore not defer the share scheme taxing date.

Example 17: Loan funded scheme A

Facts

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

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

Result

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

Analysis

Until the three years are up, if the employee leaves B Co for whatever reason, they lose their beneficial ownership of the shares for an amount that is not their market value. So the share scheme taxing date will, on the face of it, be the end of that three-year period. If the employee leaves within that period and is therefore required to transfer their rights, the sale price will be taxed. But since the sale price is the same as the amount contributed, there will be no gain or loss. Once the three-year period is up, the employee will either have no employee share scheme income (if they sell the shares back to the trustee for $10,000) or will pay tax on the difference between the value of the shares at that time and their $10,000 price (if they choose to keep the shares).

Example 18: Loan funded scheme B

Facts

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

- the shares are held by a trustee for three years;
- dividends are paid to the employee from the time the shares are acquired;
- if the employee leaves within three years, the shares must be sold back to the trustee for $10,000, which must be used to repay the loan;
- if the employee is still employed by B Co after three years, the employee can either sell the shares to the trustee for the loan amount, or choose to continue in the scheme;
- if the employee chooses to continue, the loan is only repayable when the shares are sold;
- the loan is limited recourse for the first three years (that is, during that period, the amount repayable is limited to the value of the shares at the time of repayment); and
- if the employee leaves within three years, or chooses at the end of the three years to sell the shares to the trustee, they must be sold back to the trustee for market value.

Result

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

Analysis

The requirement to sell the shares for their market value, if the employee leaves in the first three years, does not defer the share scheme taxing date. However, the limited recourse loan provides a benefit to the employee which compensates the employee for a fall in the value of the shares. Accordingly, the share scheme taxing date is the same as for example 17 – that is, the end of three years (when the loan ceases to be limited recourse) or when the shares are sold to the trustee. If the employee sells the shares for less than $10,000 (because that is their market value), the employee will have a deductible loss from the scheme under the employee share scheme rules, equal to the difference between the sale price and the $10,000 cost of the shares. They will have debt forgiveness income of an equal amount. If they retain the shares at the end of the three year period, they will have income equal to the difference between the shares' value at that time and $10,000.

Example 19: Loan funded scheme C

Facts

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

- the shares are held by a trustee for three years;
- dividends are paid to the employee from the time the shares are acquired;
- if the employee leaves within three years, the shares must be sold back to the trustee for $10,000, which must be used to repay the loan;
- if the employee is still employed by B Co after three years, the employee can either sell the shares to the trustee for the loan amount, or choose to continue in the scheme;
- if the employee chooses to continue, the loan is only repayable when the shares are sold;
- if the employee leaves within three years, or chooses at the end of the three years to sell the shares to the trustee, they must be sold back to the trustee for market value; and
- at the time of such a sale, the employer must pay the employee the amount of any decline in the value of the shares since the grant date.

Result

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

Analysis

The employer's promise to pay a bonus equal to the decline in the value of the shares is a benefit which compensates the employee for a decline in the value of the shares. The share scheme taxing date does not arise until that promise ceases to apply. If the employee sells the shares for less than $10,000 they will have a deductible loss from the scheme, which will be equal to the income they will recognise due to the payment from the employer.

Example 20: Loan funded scheme D

Facts

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

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

Unlike in example 12, there is no arrangement for the employer to pay the employee the amount of any decline in value of the shares.

Result

The share scheme taxing date is when the agreement is entered into.

Analysis

From the time the agreement is entered into, the employee has the full risk and reward of share ownership. Although the funding for the purchase is provided by the employer, the funding is full recourse and the employee holds the shares in the same way as any other shareholder.

Example 21: Vesting only in the event of a sale or IPO

Facts

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

Result

The share scheme taxing date is when the employee leaves, or C Co is sold or listed.

Analysis

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

Example 22: Blackout periods

Facts

Acme Limited (a listed company) agrees to issue 1,000 shares to Jason under an employee share scheme, if Jason remains employed for three years. Jason does so, and Acme Limited transfers 1,000 shares worth $10,000 to him on 31 December 2018. Under securities law, Jason is unable to sell the shares at that time, due to restrictions on insider trading. On 20 February 2019, the restrictions on selling the shares no longer apply and Jason sells half of his shares. The sale price is $4,200, or $8.40 per share. He sells the remaining shares six months later for $7,500.

Result

Jason's share scheme taxing date is the date when the shares vested (31 December 2018), not the end of the blackout period (20 February 2019). Jason therefore has employment income of $10,000. The $800 loss on the first sale of fifty percent of his shares will generally be a capital loss. The profit of $2,500 on the sale of the remaining parcel will generally be a capital gain.

Analysis

The issue in this example is whether the insider trading restriction defers the share scheme taxing date. A prohibition on the sale of shares does not create a risk that beneficial ownership may change, and is a right or requirement in relation to the retention of shares, not the transfer of shares. The general principle illustrated by this example is that inability to sell employee share scheme shares does not mean that the employee has received no value or that they should not be taxed (the same principle applies to employees of unlisted companies who are prohibited from selling their shares by the company's constitution or shareholder agreement). Regardless of the transfer restriction, the employee will be entitled to dividends and any increase or decrease in the shares' value over time.

The same outcome would be produced if the trading restrictions were part of the terms of the scheme as opposed to being a statutory restriction.

Example 23: Reclassifying shares

Facts

On 30 November 2018, Startup Co issued 10,000 special employee shares, which it calls E Class shares, to its CEO. The E class shares have no rights to a dividend, no voting rights, and a right to 0.1 cents per share on liquidation of the company. However, the terms of the E Class shares also provide that if Startup Co achieves certain performance hurdles by the third balance date post-issue, the terms of all or some of the E Class shares will change so that they have the same rights as ordinary shares in Startup Co. Shares whose rights to do not change, will be cancelled.

At the time the E Class shares were issued, they were valued at $1,000. The performance of the company by 31 March 2021 means seventy five percent of them are reclassified into ordinary shares, valued at $12.50 per share, giving a total value of $93,750.

Result

The share scheme taxing date for the E Class shares will be the date when their rights change or they are cancelled.

Analysis

So long as there is a material possibility that the E class shares will become ordinary shares, there is a material risk that there will be a change in their terms affecting their value (section CE 7B(1)(a)(iii)). Accordingly the share scheme taxing date cannot occur until the possibility of that change no longer exists.

Amount of income

The amount of income to the employee is the value of the shares at the share scheme taxing date (or the transfer price if transferred to a non-associate, or the amount paid for cancellation, if cancelled by the employer), less the amount paid for them.

Even where benefits are conferred on or transferred to an associate of an employee, it is always the employee who is taxed on the income. If the amount paid exceeds the value of the shares at the share scheme taxing date, the difference is deductible to the employee (sections CE 2(3) and DV 27(3)).

Apportionment for overseas service

The new rules contain an expanded income apportionment formula (section CE 2(5) and (6)). The expanded formula applies to all employees (rather than only transitional residents as in the old section CE 2(9)). It excludes from taxable income employee share scheme benefits which accrue while a person is neither New Zealand resident nor deriving New Zealand source income.

The extent of such accrual is determined by first establishing the entire period over which the benefit accrues, and then determining the proportion of that period during which the person is non-resident and not deriving New Zealand source income from their employment. The period of accrual ends once the rights vest, rather than when the income arises. So, for example, in the case of an option, the period of accrual ends once the options are *exercisable* rather than when they are actually *exercised*.

The employee share scheme income is treated as non-residents' foreign source income (which is not taxable income) to the extent of this proportion.

Example 24: Apportionment for overseas service – options

Facts

Nick is employed by Eagle Limited. On 1 June 2017 he was granted an option to buy 1,000 shares for $500. The option vests one year after it was granted (1 June 2018). He can exercise the option at any time between 1 June 2018 and 1 June 2020.

Nick is sent on secondment to Eagle Limited's Australian parent company, Philly Limited, on 30 June 2017 for two years. He does not return to New Zealand throughout his secondment and loses his New Zealand tax residence from the day he left New Zealand, as he has been away for more than 325 of 365 days, and does not have a permanent home in New Zealand.

Nick returns to New Zealand at the end of his secondment (30 June 2020). On 1 December 2018, Eagle Limited shares are worth $2 per share. Nick decides to exercise his option for $500. He therefore earns income of $1,500 on 1 December 2018.

Result

Nick's income of $1,500 is apportioned by reference to the date when the options vested (1 June 2018), not the share scheme taxing date (1 December 2018):

$$\$1,500 \times 336 \text{ days (offshore period)} \div 365 \text{ days (earning period)} = \$1,380.82$$

The earning period is from 1 June 2017 to 31 May 2018. The offshore period in this case would be from 30 June 2018 to 31 May 2018 – the number of days in the earning period when Nick was not resident in New Zealand.

Therefore $1,380.82 is treated as non-residents' foreign-sourced income and is not taxed in New Zealand. Nick will be taxable on the remaining $119.18 of his employee share scheme benefits.

Analysis

The earning period ends when the option vests, not when it is in fact exercised. However, that does not affect the principle that the amount of income that must be apportioned is determined by the value of the shares when the option is exercised.

Transfers to associates

There is no change to the treatment of transfers to associates. Such transfers do not trigger the share scheme taxing date (section CE 7B(1)(b)).

Rollover relief for transfer to new scheme

If a person's employee share scheme rights are cancelled and replaced with rights in a different scheme, the value of the replacement rights is not included in the person's income arising due to the cancellation of the original scheme (sections CE 2(2)(c) and CE 7D). In the usual case where an employee's rights in an existing scheme are simply replaced by rights in a new scheme, no income will arise under section CE 2.

The benefit provided by the replacement scheme is taxed appropriately by applying the new rules to that scheme.

TIMING AND AMOUNT OF EMPLOYERS' DEDUCTION

Sections CV 20, DV 27 and DV 28

A deduction is available to employers providing employee share benefits, which matches the income to employees in timing and quantity. Deductions previously available for other payments are disallowed where those payments would otherwise lead to a double deduction.

Background

The principle of neutral tax treatment of employee share scheme benefits supports employers being entitled to a deduction for the value of the benefit provided. The fact that the issue of shares by a company does not involve an explicit cash cost does not affect this principle. There is a transfer of value to the employee from the other shareholders, which arises whether that value is transferred as cash or as shares in the company.

Under the corporate tax system, where company expenses are deducted by the company as a separate taxpayer from its shareholders, this cost must be recognised in the calculation of income by the company, rather than the shareholders on whose behalf the income is earned and the cost incurred.

Ways to create a deduction existed under the old rules. For example, the employer could claim a deduction for:

- payment of a bonus to the employee which was used to fund a full value share acquisition;
- contributions to an employee share trust, which would then acquire shares for the employee; or
- reimbursement to a parent company to compensate it for providing employee shares.

However, the tax treatment of these transactions was uncertain, and structuring to achieve the deduction sometimes incurred unnecessary transaction costs.

There was also the potential for the amount and timing of the deduction created by such transactions to not correctly reflect the economic cost to the company of providing the employee share scheme benefits.

Key features

The new rules allow a deduction to an employer equal in amount and timing to the income derived by an employee under the new rules, and deny a deduction for any other amount incurred to provide that benefit. They do not affect the deductibility of costs incurred in establishing or operating a scheme. They also allow an employee who pays more for shares than they are worth at the share scheme taxing date a deduction for that amount.

Application date

The new share scheme taxing date and rules for calculating employee share scheme income will apply to benefits provided under employee share schemes which are not taxed under the existing rules on or before 29 September 2018.

Detail analysis

An employer is denied a deduction for expenditure or loss incurred in providing employee share scheme benefits (section DV 27(2)), except for:

- costs incurred in making a loan under the scheme or in establishing or managing the scheme (section DV 27(3)). Costs of establishing or managing include legal and accounting fees incurred in setting up the scheme, as well as on-going management fees. Deductibility of these costs is left to the usual capital/revenue tests. Costs incurred by an employee share scheme trust are treated as incurred by the employer or issuing company, as a result of the new provision treating the trustee of an employee share scheme trust as a nominee of the employer or issuing company (section CE 6);
- an amount equal to the employee's income, which is treated as a cost incurred at the same time as the employee recognises the income (section DV 27(6)-(8)). Deductibility of this cost depends on meeting the general permission and not being subject to any of the limitations. However, deductibility is not limited by the apportionment formula in new section CE 2(5) and (6); and
- amounts which are taxable to the employee as employment income other than as employee share scheme benefits (section DV 27(5)). This is intended to preserve a deduction for the cost of paying a bonus where the payment of the bonus is part of the terms of an employee share scheme.

Accordingly:

- payments to fund an employee share scheme trust to acquire shares, or to reimburse a parent for providing shares, are not deductible; and
- in order to correctly calculate their deduction, as a practical matter, employers need to either prohibit employees from transferring their rights to a non-associate before the share scheme taxing date, or place a requirement on employees to inform them of the time and amount paid in such a transfer.

In order to prevent double deductions, when shares are provided to an employee and a deduction has been taken for that provision other than in accordance with to the new section, the deduction under the new section is reduced by the earlier deduction (section DV 27(8)(b)). However, it is only the amount of any deductions in respect of costs attributable to the particular share scheme benefits which have given rise to taxable income to the employee in question which are taken into account.

Transitional arrangements

As a transitional measure, the deduction rules provide for a mechanism to make adjustments to deductions incurred before 29 September 2018 (six months after the date of enactment) (section DV 27(8)(b)(ii)).

Example 25

Facts

On 1 July 2016, a New Zealand subsidiary of an Australian multinational provided an employee with an option to acquire 5,000 shares in the Australian parent for $3 per share, exercisable on or after 1 July 2018, provided the employee was still employed by the group at that date. The employee remained employed, and exercises the option on 3 December 2018, when the shares are worth $3.50 each.

Scenario 1

Suppose that the employer had to make a recharge payment to the parent when the options were issued, of $500, being their value at that time. The employer took a deduction for this payment.

Result of scenario 1

The employer has income of $250. This is the result of the formula in section DV 27(7), being $250 − $500. The $250 is the employee's income under section CE 2(1). The $500 is the previous deduction allowed to the employer. Subsection (9) states that a negative amount is income.

Scenario 2

Suppose that the recharge payment is still $500, but it is made when the option is exercised.

Result of scenario 2

The employer has a deduction of $250. The recharge is not deductible due to section DV 27(2). Subsection (7) gives a deduction for the $250 which is taxable to the employee.

EFFECT OF DEDUCTION AND PAYMENTS ON AVAILABLE SUBSCRIBED CAPITAL

Sections CD 25 and CD 43

The new rules tax any benefit conferred on an employee by the issuance of shares in an employee share scheme in the same way as an equivalent cash payment followed by an acquisition of shares in the issuing company. Consistent with this principle, the rules provide for an increase in the employer's available subscribed capital (ASC) by the amount deemed to be paid (plus actually paid) for the shares. The rules also cater for the situation where the employer is not the company issuing the shares.

This is a taxpayer-friendly measure to ensure employee share schemes are not disadvantaged as a form of remuneration compared with an equivalent cash transaction, which would generally give rise to an ASC increase.

Background

To ensure neutrality between provision of benefits under an employee share scheme and an equivalent cash transaction, as well as providing for the income and deduction consequences, the new rules provide for changes to a company's ASC.

To do this, the rules provide for an increase in the employer's ASC by the amount deemed to be paid (plus actually paid) for the shares. The proposed rules also cater for the situation where the employer is not the company issuing the shares (this is common where the employer company is a subsidiary and the employee receives shares in the parent company).

In order to cater for the common practice of acquiring employee share scheme shares from other shareholders rather than by a fresh issue of shares, it is also necessary to ensure that the treasury stock regime can apply sensibly to employee share schemes.

Key features

The ASC provisions deal with the effect of employee share scheme transactions on the employer and (if different) the company whose shares are provided to the employee (the share provider).

The amount of the deduction to the employer will give rise to additional ASC for the employer and, if the shares issued are in the parent of the employer, the parent. In the latter case, any reimbursement paid to the parent reduces the subsidiary's ASC but does not increase the parent's ASC. If the employer has income from the issue of the shares, its ASC is reduced.

The rules also ensure that the acquisition of shares from an employee as part of an employee share scheme can be treated for tax purposes as an acquisition of treasury stock provided the shares are re-allocated within a certain period of time. This rule applies regardless of whether the shares are acquired by the company itself and not cancelled, or they are acquired by a trustee who is treated for tax purposes as a nominee of the company.

A company can choose not to apply these new ASC rules if it issues employee share scheme shares for market value.

Application date

The ASC rules apply to the provision of shares which are taxed under the new rules.

Detailed analysis

Under section CD 43, if the employer is also the company whose shares are provided, then the employer's ASC is:

- increased by:
  - the amount received for the provision of the shares (under existing section CD 43(2)(b)); and
  - the amount of its deduction for the provision of the shares (under new section CD 43(6E)(a));
- decreased by the amount of any income arising if it has income because the value of the shares provided is less than the amount received from the employee (under new section CD 43(29)).

ASC Example 1

Facts

Employer Co issues 700 shares worth $3 each to an employee for $2 per share (that is, at a $1 per share discount). The scheme taxing date is the date of issue. The employee has $700 income and Employer Co has a $700 deduction.

ASC Result

Employer Co's ASC increases by $2,100, being the total of the $1,400 received for the provision of the shares and its $700 expenditure incurred for providing the shares.

ASC Example 2

Facts

Employer Co issues 700 shares worth $3 each to an employee for $2 per share, funded by a loan from the employer. If the employee is still employed by the company after one year, the employee will receive a bonus of $1,400 grossed-up for PAYE, the net amount of which must be used to repay the loan. Otherwise, the employee must return the shares to the employer in full repayment of the loan at the time she leaves employment. After one year, the shares are worth $4 each.

ASC result

Issuing the shares gives rise to ASC of $1,400. If the shares are repurchased because the employee does not remain employed, that will usually give rise to an ASC reduction of $1,400 (unless the shares are held by a trustee or as treasury stock).
Otherwise, at the share scheme taxing date, Employer Co's ASC will increase by a further $1,400. This is made up of the $1,400 that it received from the employee for the shares and $1,400 it incurred in providing the shares (the difference between the value of the shares on the vesting date and their cost to the employee).

ASC Example 3

Facts

Employer Co issues 700 shares worth $3 each to an employee for $2 per share, funded by a loan from the employer. If the employee is still employed by the company after one year, the employee will receive a $1,400 bonus (grossed-up for PAYE), which must be used to repay the loan. Otherwise, the employee must return the shares to the employer in full repayment of the loan at the time she leaves employment. After one year, the shares are worth $1 each.

ASC result

As for ASC Example 2, at the share scheme taxing date Employer Co's ASC will first increase by $2,800 (made up of the amount received from the employee for the shares plus the expenditure incurred by the company to provide the shares). However, the ASC amount will then decrease by $700 because the value of the shares provided is less than the amount received from the employee (section CD 43(29)).

If the employer is not the company whose shares are provided, then the employer's ASC is:

- increased by the amount of its deduction for providing the shares (new section CD 43(6E)(a));
- decreased by the amount of any income arising if it has income because the value of the shares is less than the amount received from the employee (new section CD 43(29)); and
- decreased by the amount of any reimbursement paid to the share provider (new section CD 43(6F) and (6H)).

The adjustment is made to the employer's share class most similar to the shares provided under the scheme. If the decrease due to reimbursement exceeds the increase arising due to a deduction, and the excess is greater than the ASC of the relevant share class, the reimbursement amount is to that extent taxed as a dividend (section CD 43(6I)).

ASC Example 4

Facts

Parent Co, the one hundred percent owner of Employer Co, issues 700 shares worth $3 each to an employee of Employer Co for $2 per share. The scheme taxing date is the date of issue. The employee has $700 income and Employer Co has a $700 deduction.

ASC result for Employer Co

Employer Co's ASC increases by the amount of its $700 expenditure.

ASC Example 5

Facts

Parent Co issues 700 shares worth $3 each to an employee of Employer Co for $2 per share, funded by a loan from Parent Co. If the employee is still employed by Employer Co after one year, the employee will receive a $1,400 bonus (grossed-up for PAYE) from Employer Co, which must be used to repay the loan. Otherwise, the employee must return the shares to the employer in full repayment of the loan at the time she leaves employment. After one year, the shares are worth $5 each.

If the employee remains employed, Employer Co will have a deduction of $2,100, being the difference between the market value of the shares at that time (700 × $5), and their cost to the employee (700 × $2).

ASC result for Employer Co

If the employee stays employed for the year, at the share scheme taxing date, Employer Co's ASC will increase by $2,100 - the amount which is both taxable to the employee and expenditure for Employer Co under the employee share scheme rules.

ASC Example 6

Facts

As for ASC Example 5, Parent Co issues 700 shares worth $3 each to an employee of Employer Co for $2 per share, funded by a loan from Parent Co. If the employee is still employed by the Employer Co after one year, the employee will receive a $1,400 bonus (grossed-up for PAYE) from Employer Co, which must be used to repay the loan. Otherwise, the employee must return the shares to the employer in full repayment of the loan at the time she leaves employment. After one year, the shares are worth $5 each.

However, unlike ASC Example 5, if the shares are not forfeited, Employer Co pays Parent Co $1 per share reimbursement.

ASC result for Employer Co

Employer Co's ASC will increase by $1,400 if the employee remains employed, which is the difference between its $2,100 deduction and its $700 reimbursement to Parent Co.

If the shares are provided by the ultimate parent of the employer, the ASC of the parent company is:

- increased by:
  - the amount paid by the employee for the shares (under existing section CD 43(2)(b)); and
  - the amount of the employer's deduction for the provision of the shares (new section CD 43(6E)(b));
- decreased by the amount of any income arising to the employer if it has income because the value of the shares provided is less than the amount received from the employee (new section CD 43(29)); and
- unaffected by any amount paid to it by the employer (new section CD 43(20B)).

ASC Example 7: Parent Co

Facts

Parent Co, the one hundred percent owner of Employer Co, issues 700 shares worth $3 each to an employee of Employer Co for $2 per share. The scheme taxing date is the date of issue. The employee has $700 income and Employer Co has a $700 deduction.

ASC result for Parent Co

Parent Co's ASC increases by the $1,400 received for the issue of its shares plus the $700 deductible to Employer Co (for a total ASC increase of $2,100).

ASC Example 8: Parent Co

Facts

Parent Co issues 700 shares worth $3 each to an employee of Employer Co for $2 per share, funded by a loan from Parent Co. If the employee is still employed by the Employer Co after one year, the employee will receive a $1,400 bonus (grossed-up for PAYE) from Employer Co, which must be used to repay the loan. Otherwise, the employee must return the shares to the employer in full repayment of the loan at the time she leaves employment. After one year, the shares are worth $5 each.

ASC result for Parent Co

The initial issue of the shares gives rise to ASC of $1,400. If the shares are repurchased by Parent Co because the employee does not remain employed, that will usually give rise to an ASC reduction of $1,400. Otherwise, at the share scheme taxing date, Parent Co's ASC will increase by a further $2,100, the amount which is both taxable to the employee and expenditure for Employer Co.

ASC Example 9: Parent Co

Facts

As for ASC Example 6, Parent Co issues 700 shares worth $3 each to an employee of Employer Co for $2 per share, funded by a loan from Parent Co. If the employee is still employed by the Employer Co after one year, the employee will receive a $1,400 bonus from Employer Co, which must be used to repay the loan. Otherwise, the employee must return the shares to the employer in full repayment of the loan at the time she leaves employment. If the shares are not forfeited, Employer Co pays Parent Co $1 per share reimbursement. The shares are worth $1 each after one year.

ASC result

Parent Co's ASC will increase by $1,400 when the shares are issued. If the employee remains employed:

- the reimbursement of $1 per share does not affect Parent Co's ASC; and
- Parent Co's ASC decreases by $700 – the amount of the income arising to Employer Co as a result of the amount payable by the employee for the shares ($1,400) being in excess of the value of the shares at the share scheme taxing date ($700).

Treasury stock

If an employee share scheme trustee acquires shares for the purposes of the scheme, those shares are treated as acquired by the share issuer (section CE 6). The amount paid to the selling shareholder for their acquisition is a dividend, unless one of the exceptions to dividend treatment applies.

If the shares are held by the trustee, the treasury stock rules apply to them. Amendments have been made to the treasury stock rules so that they apply more clearly in such a case.

New section CD 25(1)(a) makes it explicit that the treasury stock regime can apply to an acquisition by an employee share scheme trust, just as if the shares were acquired by the company and not cancelled.

For shares allocated to an employee within one year of their acquisition by the company or a trustee, their acquisition and re-issue will be ignored by the share issuer (but not an employer who is not the share issuer) for ASC purposes. This will happen due to the operation of the usual treasury stock provisions (that is, section CD 25(19)) in relation to the amount received by the company on re-issue and the definition of "returns" in section CD 43(2)(c) in relation to the amount paid by the company to acquire the shares. Note that the shares would only have to be *allocated* to the employee under the scheme within 12 months of acquisition to qualify for treasury stock treatment – they do not have to be transferred to the employee.

The only time any ASC adjustment is required is when shares are not allocated to an employee within one year of acquisition, issue or ceasing to be allocated to another employee, or when shares are issued for other than market value.

Shares which are allocated to an employee within a year and then forfeited by the employee are treated as acquired by the company at that time *for the amount the trustee paid for them when originally acquired* (new section CD 25(7)). The shares will continue to be dealt with as treasury stock, but with a new acquisition date.

Shares which are not allocated within one year are treated as having been acquired on market and cancelled (amendments to section CD 25(2)(b)).

ASC Example 10

Facts

An employee share scheme trust for Employer Co acquires 700 Employer Co shares on market for $2.50 per share. Six months later, when they are worth $3 per share, it allocates them to an employee for $2 per share. The purchase price is funded by a loan from Employer Co. If the employee is still employed by Employer Co after one year, the employee will receive a $1,400 bonus from Employer Co (grossed-up for PAYE), which must be used to repay the loan. Otherwise, the employee must return the shares to the employer in full repayment of the loan at the time she leaves employment.

After one year, the shares are worth $5 each.

ASC result for Employer Co

The trustee's acquisition of the shares is treated as an on-market acquisition of treasury stock by Employer Co. Because the shares are allocated to an employee within 12 months of acquisition, the acquisition is not treated as reverting to an on-market cancellation under section CD 25(2). Therefore the amount paid to acquire the shares does not reduce Employer Co's ASC and the $1,400 paid by the employee to acquire the shares does not increase Employer Co's ASC.

If the employee does not stay for 12 months, Employer Co will be treated as acquiring the shares at that time for $2.50 per share, the amount for which they were initially acquired on market. This acquisition will not reduce Parent Co's ASC if the shares are allocated to another employee within 12 months.

Shares issued for market value

The ASC rules applying to employee share scheme shares can be disregarded by a company if it issues employee share scheme shares for market value, or a reasonable estimate of market value, at the time of issue. In this case, the company's ASC is not affected by the amount of any income or deduction arising due to any difference between the issue price and the value of the shares at the share scheme taxing date.

ASC Example 11: Loan funded scheme

Facts

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

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

The employee remains employed for three years, and chooses to continue in the scheme, as the shares are worth $18,000 at that time.

Result

B Co's ASC will increase by $10,000 when it issues the shares. Prima facie it will also increase by $8,000 at the end of year three, unless the company elects to the contrary.

Analysis

The $10,000 received by B Co is ASC under section CD 43(2), because it is within the definition of "subscriptions". The $8,000 is also included in "subscriptions" under section CD 43(6E). However, B Co can elect out of section CD 43(6E), because it issued the shares for their market value (section CD 43(6EB).

EXEMPT EMPLOYEE SHARE SCHEMES

Sections CW 26B, CW 26C, CW 26D, CW 26E, CW 26F, CW 26G, DV 28, and section 63B of the Tax Administration Act 1994.

The Income Tax Act 2007 provides a concessionary regime to employers who offer shares to employees under certain widely-offered "exempt employee share schemes".

The old rules governing such exempt schemes were out of date, complex and no longer fit for purpose. They also did not fit within New Zealand's broad base, low rate tax framework. The new rules:

- modernise and simplify the criteria for these schemes, including removing employers' ten percent notional interest deduction;
- increase the monetary threshold for the schemes (which has not been increased since 1980); and
- address the current ability for employers to claim unintended deductions for the cost of providing the exempt share benefit to employees.

Background

Since the 1970s, the Income Tax Act has contained a concessionary regime to encourage employers to offer shares to employees under certain widely-offered employee share schemes. The concession is on the basis that the schemes are designed to increase employee engagement at all levels of the company and align employee and shareholder incentives. They may also assist employees to develop and improve financial literacy skills.

There were previously two main tax benefits available under the regime:

1. Exemption for employee: The value of a benefit received by an employee under a concessionary scheme is not taxable to the employee.
2. Deemed interest deduction for employer: The employer is given a deemed deduction of ten percent 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.

Another benefit under the regime is that interest-free loans made under an exempt scheme are automatically exempt from Fringe Benefit Tax (FBT). The FBT-exempt status of the loans is a limited 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 real benefit of the specific FBT exemption is that the interest-free loan can be FBT-exempt regardless of the company's dividend paying policy.

There were various issues with the old regime:

- the regime was complex and inflexible;

- the tax benefits of the regime were uncertain and poorly targeted;
- the regime did not explicitly limit the amount of tax-free benefit that can be conferred;
- there were some minor drafting issues with the legislation; and
- the maximum amount an employee could pay for shares ($2,340 over a three-year period) had not been adjusted since 1980, and this meant as a practical matter that the benefits available under the regime were very limited. Adjusted for wage inflation, the figure would now be around $13,000.

Key features

The new rules simplify and clarify the legislation relating to exempt schemes, while retaining many of the key features of the original schemes and their tax treatment. In many cases, the requirements are relaxed. Where the original policy was no longer appropriate or unintended consequences arose, the amendments address this.

Under the new rules, shares provided to employees under schemes that meet certain criteria (described below in the detailed analysis) are exempt income to the employees. Benefits provided under schemes that qualified for the old tax-exempt treatment simply continue to qualify under the new legislation, but such schemes are now entitled to provide the same level of exempt benefits as new schemes.

For all exempt schemes, from 6 April 2017, employers are explicitly denied a deduction for the cost of providing the shares (other than scheme management and administration costs) and the ten percent notional interest deduction is repealed.

The automatic exemption from FBT for loans provided under exempt schemes in section CX 10(2) continues.

Application dates

The amendments generally apply from 29 March 2018. However, new section DV 28, which denies employers a deduction for expenditure or loss in relation to an exempt employee share scheme (other than establishment or operational costs) applies on and after 6 April 2017 if shares under the exempt scheme were acquired other than in the ordinary course of the scheme.

Detailed analysis

Income tax exemption for shares provided under exempt schemes

Section CW 26B provides that amounts derived from exempt schemes are exempt income.

While a tax exemption for employment income does not fit generally within New Zealand's broad-base, low-rate tax framework, given there is a limit on the amount of benefit that can be provided under the scheme ($2,000 per employee per annum) and the scheme has to be offered to almost all employees, it is appropriate to retain the tax exemption to minimise compliance costs.

Employer deduction for shares provided under exempt schemes

There were several potential deductions associated with exempt schemes:

1. the ten percent notional interest deduction with respect to employee share loans;
2. costs associated with setting up and running the scheme; and
3. in some cases, the direct or indirect costs of acquiring shares for the scheme.

The ten percent notional interest deduction in item 1 above has been repealed. The original policy rationale for this benefit is unclear and it is inconsistent with our BBLR tax framework.

New section DV 28 denies a deduction for any costs associated with exempt schemes, other than administrative and management fees associated with setting up and running the scheme. This is on the basis that when the rules were originally enacted (in the 1970s) it was not envisaged that employers would be eligible for a deduction (as there is no deduction for issuing shares). It has subsequently become apparent that employers can adopt structures that allow them to claim deductions. These deductions are unintended and should never have been available. Therefore, employers are not able to extend these unintended deductions by accelerating the purchase of a large parcel of shares through a trust, which are then allocated to employees over a number of years in the future. However, provided that the shares have been acquired in the ordinary course of the scheme, a later application date (29 March 2018) is appropriate.

This ensures that the unintended deductions identified in item 3 above are no longer available, but the deductions identified in item 2 are still available, subject to the usual limitations. This is consistent with the general deductibility provision for employee share scheme benefits in new section DV 27.

Meaning of exempt scheme and criteria for qualifying for exemption

The new rules have been designed to ensure existing schemes (that is, schemes in existence before the effective date of the new rules) that meet the criteria described below can continue to operate without unnecessary disruption. Therefore, to the extent possible the existing rules have been retained and simply clarified.

Existing exempt schemes approved by the Commissioner under previous legislation (for example, section DC 12 of the Income Tax Act 2007), continue to be "exempt employee share schemes" and are eligible for the tax exemption, provided they continue to meet the criteria under which they were approved as modified by the increase in the benefit level in section CW 26C(2).

The underlying policy of the criteria is to ensure:

1. the scheme is genuinely offered to the vast majority of employees on equal terms – for example, it cannot just be targeted towards executives;
2. related to 1, all employees have to be able to afford to participate in the scheme, not just the more highly paid employees. This is achieved by limiting the cost of the shares that can be offered, requiring employers to provide financing for any cost or because the employee does not have to pay anything for the shares;
3. there is a limit on the benefit that can be provided; and

4. the scheme is genuinely a share scheme and not just a mechanism to provide tax-free cash to employees (this is why there is a restriction period).

Criteria

To achieve this policy, all the following proposed criteria must be met in order for a scheme to be exempt.

- 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 (section CW 26C(2)(a)).
- The maximum value of shares provided under an exempt scheme is $5,000 per annum (section CW 26C(2)(b)).
- The maximum discount an employer can provide to an employee is $2,000 per annum (section CW 26C(2)(c)). This means that the most an employee can spend buying shares per annum is $3,000 ($3,000 plus the $2,000 discount means a maximum value of $5,000 worth of shares). This equates to a maximum cost of $9,000 over three years.
- Ninety percent or more of full-time permanent employees who are not subject to securities law of other jurisdictions must be eligible to participate in the scheme. If the scheme applies to part-time employees or to seasonal employees, the same threshold applies (section CW 26C(3)(a)-(c)). Previously, all full time employees were required to be eligible to participate.
- If the scheme has a minimum spend requirement, the amount can be no more than $1,000 per annum (section CW 26C(3)(d)). This is the updated equivalent of the old section DC 13(4) and increases the $624 per three year figure.
- Any minimum period of service which may be required before an employee becomes eligible to participate must not exceed three years (or the equivalent of three years full-time service) (section CW 26C(3)(e)).
- If the employee is required to pay any amount for the shares, then the employer must provide a loan for that amount or allow the employee to pay for the shares in instalments (section CW 26C(4)(a)).
- Loans to employees for the purchase of shares must be free of all interest and other charges (section CW 26C(4)(b)).
- Employees will repay loans 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 (section CW 26C(4)(d)). This requirement can be satisfied by arrangements where shares are acquired regularly by the employee (for example, each payday) with the entire purchase price paid off each time, and also to arrangements where shares are acquired once and the purchase price is paid off in instalments.
- Generally speaking, the shares must be held (either by the employee or by a trustee of a trust on behalf of the employee) for the longer of three years and when the loan is repaid – this is to ensure that the scheme is really a share purchase scheme, and not a mechanism for providing cash remuneration. However, the employee is not required to hold the shares beyond the date their employment ends. Also, if the employee has paid full market value for the shares, then they only have to hold them until they have fully repaid the loan (section CW 26C(7).

- The employee can choose to withdraw from the scheme by giving the employer one months' notice and have their shares purchased back for the lesser of market value and cost (section CW 26C(6)).
- If participation in the scheme is causing serious hardship for the employee, the terms of payment can be varied or employees can be allowed to withdraw from the scheme and receive the market value of their shares (section CW 26C(5)).
- If the employee leaves employment before the three years is up, then:
  - if they leave because of death, accident, sickness, redundancy or retirement at normal retiring age they can keep the shares (subject to repayment of the loan) or have the shares bought back for the lesser of market value and cost; and
  - if they leave for any other reason, the shares are bought back at the lesser of cost and market value (section CW 26C(6) and (9)).
- The exempt scheme does not require approval by the Commissioner of Inland Revenue, however, the Commissioner must be notified of the scheme's existence and the employer must advise the Commissioner of shares granted and contributions received under the scheme on an annual basis, in an annual return (section 63B of the Tax Administration Act 1994).
- There is no requirement for a scheme to have a trustee – many schemes have trustees as a matter of convenience. Removing this requirement provides greater flexibility (especially for small employers who may not want the administrative expense of operating a trust for a small scheme).

TECHNICAL, CONSEQUENTIAL AND TRANSITIONAL MATTERS

Sections CE 2, CE 6, CZ 1, EX 38, GB 49B, HC 27, and section 3(1) of the Tax Administration Act 1994

A number of transitional and consequential provisions are needed to support the core amendments. These provisions:

- specify a cost base for shares acquired under an employee share scheme (new section CE 2(4));
- provide for the treatment of employee share scheme shares subject to the foreign investment fund (FIF) rules (amended section EX 38);
- specify the treatment of employee share scheme trusts (new section CE 6 and repeal of previous section HC 27(3B));
- introduce a specific anti-avoidance rule to counteract tax avoidance transactions with respect to employee share schemes (new section GB 49B);
- make an amendment so that shortfall penalties apply to employers who do not take reasonable care in reporting employee share scheme benefits (amendments to the definition of "tax shortfall" in section 3(1) of the Tax Administration Act 1994);
- provide transitional rules for existing schemes to ensure taxpayers have sufficient time to amend schemes (if necessary) to take account of the new law following enactment of the Bill (new section CZ 1); and
- replace the former terminology – share purchase agreement – with the new term – employee share scheme – throughout the Income Tax Act 2007 and Tax Administration Act 1994.

Application date

There are various application dates for each of the amendments, as specified below.

Key features

Cost base

Income from an employee share scheme benefit is added to the cost of the shares for tax purposes (new section CE 2(4)). Similarly, a deduction reduces the cost base.

This provision applies from 29 September 2018.

FIF regime

The new rules effectively exclude from the FIF regime employee share scheme shares which are treated as owned by the employee for tax purposes but for which the share scheme taxing date has not arisen. Before that time, it is appropriate to tax the dividends on the shares, but not appropriate to tax any change in value, since that will be taxed when the shares give rise to income under section CE 2. See amendments to section EX 38.

This provision applies from 29 September 2018.

Trusts

As referred to above, an employee share scheme trustee is treated as the nominee of the employer and (if different) the share issuing company to the extent of is activities on their behalf (new section CE 6). This means that the activities of the trustee on behalf of those companies are treated as undertaken directly by the companies themselves. They will therefore have no effect on the trustee's taxable income. Like any other nominee, the trustee will still have to file a tax return if it is remunerated for its services.

Section HC 27(3B), which dealt with the situation where an employer has claimed a deduction for a settlement on an employee share scheme trustee, has been repealed, as such settlements will no longer be deductible.

These provisions apply from 29 September 2018.

Specific anti-avoidance provision

A new specific anti-avoidance provision allows the Commissioner to counteract any tax advantage gained from an arrangement which attempts to circumvent the intent and application of the share scheme taxing date or employee share scheme definitions.

This provision applies from 29 September 2018.

Penalties

The definition of a "tax shortfall" has been amended so that an employer who is required to report the amount of an employee's share scheme income in a tax return, and who fails to take reasonable care in determining the amount of that income, is liable for the same shortfall penalty whether or not the employer has elected to pay PAYE on the benefit. There is no basis for differentiating in this respect between employers who do and those who do not withhold PAYE.

This provision applies from 29 March 2018.

Transitional rules

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.

Accordingly, it is important to provide sufficient transitional measures for existing and contemplated employee share schemes. 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.

To balance these competing objectives, there are three types of transitional relief, pursuant to which the new rules will not apply to employee share benefits provided after enactment.

The first is the general implementation rule in section 2(34), which provides that the new taxing provisions only take effect from 29 September 2018. This means the new rules will not apply to benefits where the share scheme taxing date is before 29 September 2018.

The second and third cases of transitional relief apply where the share scheme taxing date is on or after 29 September 2018.

The second case applies to shares granted or acquired (including by a trustee) before 12 March 2016, when the officials' issues paper *Taxation of employee share schemes* was published. Such shares are never subject to tax under the new rules (see section CZ 1(b)).

The third case applies to shares granted or acquired (including by a trustee) between 12 May 2016 and 29 September 2018. Such shares are not taxed under the new rules provided that:

- they were not granted or acquired for a purpose of avoiding the application of the new rules; and
- the share scheme taxing date under the new rules is before 1 April 2022.

In this case, if the shares are taxable under both the old and new rules, the amount taxed under the old rules reduces the amount taxable under the new rules – see section CE 2(1).