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Deputy Commissioner, Policy & Strategy
Policy & Strategy, Inland Revenue
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Dear Madam

KPMG submission - taxation of employee share schemes: start-up companies

KPMG is pleased to make a submission on the Officials' Issues Paper (the "issues paper") and we apologise for the delay.

General comments

We support Officials revisiting the proposals for taxing employee share schemes implemented by start-up companies ("start-up ESSs") to address, in particular, the liquidity issues that employees of start-ups face when share benefits are received.

The broad proposal, which is to defer the recognition of ESS income until there is a "liquidity event" (such as listing of the shares or sale of the company) to fund the tax on the income, in our view, is a reasonable approach to address the liquidity concerns. We are therefore supportive of the objective of the rules, which is to make it easier for employees (and start-up employers) to comply.

It is disappointing, however, that the issues paper does not take a more holistic view on the appropriate taxation settings for start-up ESSs. That is, if New Zealand is to develop a strong and sustainable knowledge economy, we believe there is a role for the taxation system to play its part. In particular, the view that there should be no fiscal cost to simplification (which is what the proposed deferral regime is aimed at) needs rethinking.

The use of share benefits, in lieu of cash remuneration, serves two purposes. For start-ups, where "cash is king", the issuance of shares mitigates a significant cash cost that would otherwise be incurred. Secondly, it promotes greater engagement by (and retention of) key employees during a critical period in the business lifecycle. Therefore, we are of the view that the tax rules should not discourage the use of start-up ESSs. Further, we believe that when designing the rules for taxing these types of benefits, the system should "err" in favour of their use and simplicity.

We are therefore concerned that the issues paper takes the view that the "other possibilities" (discussed in paragraphs 3.9 and 3.10) under-tax or are inconsistent with current tax settings and, therefore, do not warrant further consideration. Given that the justification for these new rules is the special circumstances affecting start-up ESSs, it seems strange that normal tax policy paradigms are then applied to potential solutions, to exclude them.

The analysis of the "non-assessable / non-deductible" ("NAND") approach to taxing start-up ESSs, and allowing employers' deductions to be cashed-up, receive only a cursory analysis as a result. We do not believe that appropriate detailed consideration has been given to these or other options. For example, there is no quantification of the fiscal cost/risk to Government from these options. Without such analysis, it seems premature to conclude the deferral regime is the preferred option.

Detailed comments

We outline below our specific comments and recommendations on the deferral regime:

We agree the tax payment date should be deferred until there is a liquidity event (such as a listing or sale), however, the taxable benefit should be able to be calculated at the time the employee receives the shares free of any (substantive) employment conditions.

This is necessary to ensure that start-up ESS benefits are not over-taxed (that is, only the genuine employment income component, and not the additional capital gain, is taxable).

We note that the *"uncertain and difficult exercise"* of valuing shares in start-ups is one of the reasons for deferring both the taxing point and the calculation of taxable value. While we accept there may be difficulties in valuing the shares, we do not see this issue as insurmountable.

Further, if the shares are issued to an employee at an early stage (when the idea / product / company is untested), the value of the benefit conferred should reflect this. Any subsequent increase in share value (e.g. from that idea/product subsequently being developed and commercialised by their employer) does not relate to the person's employment income and should not be taxed. (However, this will be the case if the taxing date is on listing or trade-sale of the business.) We note that there can often be long lead times between a start-up issuing the shares and a particular liquidity event occurring. This will, therefore, invariably result in over-taxation under the deferral regime.

Accordingly, we recommend that the option be available for a start-up (or the employee) to base the ESS income calculation on an independent valuation at the time the shares are held free of any (substantive) employment conditions (i.e. when the relevant criteria in the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill are met).

If, however, the employee or company does not wish to incur such costs, the amount of the ESS income can be calculated at the time of the liquidity event.

While not our preference, if deferral of the payment of tax until a liquidity event is a fiscal concern, then an appropriate finance charge could be applied to compensate the Crown. (This is not preferred due to the complexity of what should be a simple rule. Further, any finance charge should not be set at a penal rate, like current use of money interest rates are.)

The definition of a "start-up company" for the purposes of the deferral regime should not exclude certain industries (such as start-ups in the property, construction, insurance or extraction industries).

The proposal to limit the scope of the deferral regime based on the industry in which the start-up operates will result in arbitrary outcomes. There is no support for the view in the issues paper that these companies (and their ESSs) do not have the same constraints as companies in the technology sector for example, particularly around the liquidity of their shares.

We are concerned that this will be akin to the Government "picking winners" (and potentially "losers"), when these tax rules should be industry agnostic.

We agree the proposal should only apply to unlisted companies (given the liquidity issues being the main driver). The turnover threshold should be NZ$50m (to align with the Australian definition) or, if that is not supported, NZ$20m.

The suggested criteria for defining a "start-up" company appear to be based on listing status (i.e. unlisted), turnover (less than NZ$10m), and age (less than 10 years old).

We agree that the liquidity constraints would not be applicable if the company is listed, therefore, it is appropriate that the proposal be limited to unlisted entities.

In relation to a turnover threshold, we suggest basing this on the Australian threshold of $50m (in NZD). We note that there is invariably a degree of subjectivity around setting any threshold figure. Our aim is to ensure that the widest range of start-ups can opt into the deferral regime, to defer the "cliff face". If this is considered too high, then the threshold should be set at NZ$20m.

Consideration should also be given to allowing alternative criteria as a substitute for turnover, such as R&D labour intensity (which is used as the entry criteria in the R&D loss cash-up rules).

We support a "less than 10 year old" rule as the final criteria.

We recommend the deferral regime be elective by the employee.

Our support for the deferral regime is based on this addressing genuine concerns around liquidity. While this will generally be the case where a start-up's shares cannot be traded, meaning there is no cash-flow but a tax liability nevertheless, some employees they may have other sources (e.g. salary or wages, investment income or wealth generally) from which to pay the tax, meaning the liquidity issue does not arise for them.

We expect this will particularly be a consideration if there is no option but for the calculation of ESS income (the taxable amount) to be based on the value at the time of a "liquidity event", under the deferral regime. Employees may wish to opt out to avoid over-taxation.

Therefore, we recommend that the deferral regime, if implemented as proposed in the issues paper, be elective rather than mandatory and at the employee's choice (as they will suffer the tax impost). We note this is consistent with the approach adopted in relation to deducting PAYE on ESS income.

We support the deduction to the start-up being able to be deferred. However, there should be the option to defer the deduction post the employee's taxing date (without reference to shareholder continuity). Alternatively, we support the ability to "cash up" the deduction (similar to the R&D loss cash-up rules).

We agree with the proposal to allow deferral of the deduction for share costs to a future date. The proposal in the issues paper is to align the timing of the deduction with the share taxing date for the employee.

However, we believe that start-ups should be able to defer a deduction to an income year after the year in which the employee has ESS income. This is to address potential forfeiture of the deduction if it results in a tax loss, which will be subject to shareholder continuity requirements. The deferral option should be available as long as the company continues to meets the "start-up" definition.

Alternatively, we recommend that the "cash up" option (outlined in Chapter 3 but summarily discounted) be reconsidered. We note the R&D losses cash-up rule, on which this would be based, provides a timing benefit for taxpayers. Its driver, to deliver a cash-flow benefit to cash-constrained business, also applies here.

The view in paragraph 3.10 that *"it would be a significant departure from NZ's current taxation of employment remuneration"* and *"It does not seem appropriate from a policy perspective to allow a cash out to apply to a certain form of remuneration and not to other expenses"*, again, misses the point that the objective should be to address a genuine business concern. (The latter statement in paragraph 3.10 is also incorrect, as the R&D losses cash-up option means that there are other expenses for which a different approach has been adopted.)

We recommend that any record keeping and disclosure requirements be incorporated into the new employment income reporting proposals, to avoid duplication.

The Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill contains new employee income (and PAYE) reporting proposals which will come into force from 1 April 2019 (or earlier by election).

Given our expectations about the policy and legislative track for the start-up ESS proposal, we assume any new rules will apply from a similar date. Therefore, it makes sense for the employee income reporting proposals to have explicit considerations about the disclosure requirements for start-up ESSs.

We are concerned to ensure that reporting of (and on) start-up ESSs is not a standalone process, which requires employers to make further changes to their payroll systems.

Further information

Please do not hesitate to contact us, Rebecca on 09 367 5926 or Darshana on 09 367 5940, if you would like to discuss our submission.

Yours sincerely

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