KPMG

TaxMail

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Regular commentary from our experts on topical tax issues

Issue 1

Updated employee share scheme taxation proposal

Snapshot

Inland Revenue Policy has released a report with updated proposals for taxing employee share scheme ("ESS") benefits. This report expands on the proposals previously outlined and provides further examples (you can read our taxmail on the original proposals here). Submissions on the updated proposals are due 30 September 2016.

Key points

There is nothing substantively different from the original proposals (other than for start-up companies). However, some additional detail has been provided.

The main points of note are:

1. *The report confirms that ESS benefits, which depend on continued employment, should be taxed once that employment has occurred (i.e. conditions have been satisfied).*

This latest iteration suggests that the core principles for taxing ESS benefits are unlikely to change between now and draft legislation.

Employers should therefore be considering the impact of the proposed rules on their existing ESSs.

During this latest consultation round there is also an opportunity to address any practical concerns in a submission.

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The report maintains this is the case with all employee benefits. We find this to be at odds with the general taxing principle for employment income: remuneration is taxed "when it is received". By way of example, a relocation allowance is taxed when it is received, even though there may be a requirement for this to be paid back if the employee resigns prior to the end of a restrictive period.

There is clarification that the focus of the taxing point is the time that an employee has economic ownership in the underlying ESS benefits. An obligation placed on an employee to transfer ESS benefits at market value will not defer the taxing point. The updated proposals also confirm Officials' view that ESS benefits (and losses) dependent on future employment are not on capital account. However, the practical result is that winners are taxed but losers do not get a tax deduction.

2. *Options should continue to be taxed when exercised.*

This view is supported by KPMG and a number of our clients who prefer the taxing point to coincide with receipt of the benefit and the ability to fund the tax.

3. *Employers will, as originally proposed, be able to deduct ESS benefits when taxable to employees.*

The update however proposes to align existing deductions (for payments to parent companies and to trusts for shares) with this timing and valuation rule.

4. *Special rules for start-up companies were not supported in submissions, so no special rules are proposed.*

The report outlines instead principles that can be applied, so a scheme can be designed to support the needs of start-ups and other companies that are cash poor but needing to attract and keep talent. The scheme design suggested in the report operates like an option with a long window to exercise. This would mean the taxing point would be delayed to the point of exercise but the benefit is determined against the full market value at the time of exercise. As noted above, the ability to align the taxing point with the "cash" point is seen by many of our clients as positive. The potentially higher taxable value is offset by the better ability to fund the resultant tax.

5. *The tax-free status of widely-offered schemes will be retained, but with some modifications to the concession.*

Retention of tax-free status for widely-offered schemes was broadly supported in submissions (including by KPMG). The proposed modifications both clarify and tighten the rules.

6. *The transitional period has been moderately extended for certain ESSs following consultation.*

The update proposes to extend the "grand parented" tax treatment to ESS benefits issued within six months following enactment of amending legislation, if the terms of the ESS were in place before 12 May 2016. ESS benefits granted within six months following enactment, where the taxing point under the new rules will be prior to 1 April 2022, would also be grand parented under the updated proposals.

Timing

Based on the time frame for submissions, we estimate that a Tax Bill with the new ESS tax rules is likely to be released around February/March 2017.

Actions

This latest iteration suggests that the core principles for taxing ESS benefits are unlikely to change between now and draft legislation. Employers should therefore be considering the impact of the proposed rules on their existing ESSs.

During this latest consultation round there is also an opportunity to address any practical concerns in a submission.