KPMG

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Regular commentary from our experts on topical tax issues

Issue 3

New rules for employee share schemes

Snapshot

An Officials' Issues Paper proposes changes to the taxation of employee share scheme (ESS) benefits.

The focus is on conditional and "option-like" ESS arrangements. Officials' concern is that these schemes allow what is, in their view, taxable income, to be treated as tax-free capital gains, under the current rules. The proposal in the Issues Paper is to calculate the taxable benefit when the employee holds the shares free from any substantive conditions, rather than simply when the shares are acquired. As this is at a later time, compared to the current rules, the shares will have potentially increased in value and there will be a larger taxable benefit. The Issues Paper also proposes:

- transitional rules for existing ESS arrangements;
- allowing a deduction for the cost of ESSs;
- deferring the taxation of start-up company ESSs to when the shares are sold or listed; and
- additional employer reporting on ESSs.

Officials' concern is ESS benefits are calculated too early. This reduces the amount that is taxable.

Substantive employment conditions, which have not been met, such that the share rights have not economically fully vested, will mean the taxing point is deferred.

The trade-off? While tax is deferred, it will apply to a potentially larger share benefit amount.

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Both how much is taxed, and when it is taxed, is a current concern for the Commissioner (refer our previous taxmail on Inland Revenue's ESS Risk Alert). The proposals will legislatively address those concerns. Employers should review their existing and proposed ESSs in light of the proposals.

What's being proposed?

Proposed treatment of different types of ESSs

<table>
<tr><th>Type</th><th>Features</th><th>Current tax treatment</th><th>Proposed tax treatment</th></tr>
<tr><td>Unconditional ESS</td><td>Shares (or options) acquired free of conditions.</td><td>Share purchase plan: taxed at issue on difference between market value and acquisition price of shares.

Share option plan: taxed at exercise on difference between market value and strike price of shares.</td><td>No change.</td></tr>
<tr><td>Conditional ESS</td><td>Shares are subject to future employment conditions.</td><td>Same as above.

The concern is that any increase in the value of the shares from when they are purchased or received until the conditions are satisfied is tax-free.</td><td rowspan="2">Taxable benefit determined when "substantive conditions" are met. Substantive conditions are <u>NOT</u> met:

• when there is a real risk of forfeiture of the shares;

• where the employee has a right to transfer the shares back to the company (e.g. in satisfaction of a loan used to acquire the shares);

• where the employee is protected against loss due to a decline in the share price (e.g. by way of a non-recourse loan or other payment);

• when employment-related conditions have not been satisfied; and

• when contingent rights associated with the shares have not been exercised or extinguished.</td></tr>
<tr><td>"Option-like" ESS</td><td>Have terms and conditions (often based on the price of the shares) and other features that make the arrangement similar in economic effect to an option to acquire the shares.

Option-like arrangements will also often have employment conditions in addition to the price conditions.</td><td>Under current practise, this is treated as a share purchase and the benefit is generally valued at nil. This is the case where the arrangement provides for the purchase of shares for full consideration through the use of a limited recourse loan.

The concern is that this undervalues the employment-related benefit. This is the subject of last year's Inland Revenue Risk Alert which suggests the tax avoidance rules may apply to such arrangements.</td></tr>
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Deductibility of ESS costs

Currently, a company may not deduct the value of shares issued under an ESS. This is because the value is either not a cost or is a capital expense for the company. The Issues Paper proposes allowing a deduction.

The deduction will be equal to the employee's share benefit income and would be deductible when it is taxable to the employee.

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Start-up company ESS tax deferral

The concern is that for many start-up companies the ESS benefit will be difficult to value and any resulting tax difficult to fund. This is due to the lack of an active market for the shares. (While the employer could pay the tax, start-up companies typically experience cash-flow problems. The problem is simply transferred to the employer.)

The proposal is to allow employees of start-up companies to defer the taxing point until the shares are sold or listed. Use of money interest would apply to any deferral of the tax and the start-up's deduction would be similarly deferred.

There are a number of design issues highlighted for further feedback including:

- The definition of eligible start-ups.
- Whether the deferral should be mandatory or optional and/or limited to non-dividend paying shares.
- The need for "safe harbour" valuation rules for shares issued under an ESS.

Transitional rules

The Issues Paper proposes limited "grand parenting" of existing ESS arrangements. This would expire at the end of the third full year following enactment. For example, assuming a June 2017 enactment, the new rules would apply to all ESS benefits paid on or after 1 April 2021.

Other issues

The Issues Paper also seeks feedback on:

- Retention of the current "widely offered share purchase scheme" exemption. (Under the exemption, shares worth up to $2,340 over three years can be acquired tax-free if certain other conditions are met).
- Whether specific ESS reporting requirements, over and above those proposed under the PAYE proposal for ESS benefits, should be implemented. One option is for employers to file a detailed monthly ESS report.

Our view

A review of the taxation treatment of ESSs has been on the agenda. Draft legislation was introduced in 2015 to allow employers to deduct PAYE on employee share benefits and impose new mandatory ESS benefit disclosure obligations. Separately, Inland Revenue released its Risk Alert on ESSs last year. The Issues Paper proposals address the concerns raised: the non-taxation of what Officials consider to be the "real" value of the employment benefit under conditional and option-like ESS arrangements.

Officials' concern is that calculating the taxable benefit based on the formal acquisition date of the shares, when the economic rights to the shares have not fully vested, does not properly value that benefit. Officials' expectation is that a potentially larger amount is taxable when those rights do vest, free of substantive conditions. That is what (and when) the proposals seek to tax.

In practice, the need to determine what is a substantive condition and when these requirements have been met will create uncertainty. Much like the tax residence test for determining a person's Permanent Place of Abode, different features will be given different weights by employers, employees and Inland Revenue. There is, therefore, potential for dispute over the taxing point and value of the benefit.

We welcome the suggestion that employers should receive a deduction for the cost of their ESSs. This recognises that the economic cost of an ESS is similar to cash remuneration. This will particularly be the case for cash-flow constrained companies, such as start-ups. The proposal to allow deferral of tax on ESS benefits received from start-ups, until there is liquidity, is worth a closer look. However, we note the potential interest charge will make this less attractive to employees.

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There are a number of detailed design issues which employers will need to work through carefully. The proposed transitional rule will impose different taxing points under the existing and new rules (i.e. when shares are acquired vs when substantive conditions are met) for employees depending on when the ESS transaction arises. This will need to be communicated to employees and/or reflected in employers' PAYE systems. Similarly, if more detailed share benefit information needs to be reported to Inland Revenue, say monthly, systems will need to be able to accommodate this.

The key commercial objectives of an ESS are typically to encourage greater employee engagement, and to retain the loyalty of key persons in the business. The design of an ESS will reflect these and other commercial drivers. This may mean inclusion of features which Officials perceive to be aimed at reducing the level of the taxable benefit. The proposals are therefore likely to create a tension between the commercial objectives of the ESS and employees' tax concerns. Businesses will need to consider whether their existing ESS arrangements strike an appropriate balance.

Submissions are due by 22 June. Employers should take the opportunity to work through the Issues Paper, and provide feedback, to ensure their practical concerns are highlighted to Officials.

For further information

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