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GMS Flash Alert

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New Zealand - Updates to Proposals for Taxing Employee Share Schemes

Inland Revenue has been consulting on updates to proposals to change the taxation treatment of employee share scheme ("ESS") benefits in New Zealand[1]. (The original proposals were released for consultation in May 2016.[2]) The updates do not substantively change the original proposals (other than confirming there will be no special rules for start-up company ESSs, including deferral of the taxing point). Some additional detail and clarification however have been provided on how the new rules for taxing ESSs would apply.

WHY THIS MATTERS

Under both the original proposals and the updates, the taxable ESS benefit will arise (i.e., be calculated) when the employee holds the shares free from any substantive employment conditions (or other restrictions), rather than simply when the shares are acquired. Since this is typically at a later date, compared to current rules, the shares will have potentially increased in value, resulting in a larger taxable benefit. This could translate into potentially higher costs for international assignees participating in ESSs, who become taxable in New Zealand on those benefits.

For employers, it is proposed that they will be able to deduct the value of shares issued under an ESS in all circumstances. (Currently, an employer generally cannot deduct the value of employee share awards, for New Zealand taxation purposes.) This could help mitigate employee compensation-related costs and make employee share rewards more attractive (as the tax cost will be similar to cash remuneration). The proposed deduction would be equal to the employee's taxable ESS benefit amount and would become available when the ESS benefit is taxable to the employee.

Background

Both how much is taxed and when under the current taxation rules for ESS benefits have been concerns for the New Zealand Inland Revenue. Inland Revenue has previously identified ESS arrangements with features it considers artificially lower the taxable value of ESS benefits (e.g., by bringing forward the taxing point to when the shares are legally issued, notwithstanding the employee may not have full legal and economic rights to the shares until a future date, when substantive employment conditions have been met).

Under the original proposals, a taxable ESS benefit would arise when the employee holds the shares free from any substantive conditions/restrictions, rather than simply when the shares are legally acquired. The taxable benefit would be calculated accordingly – as noted earlier, this would potentially be at a later time, compared to the current rules, resulting in a larger taxable benefit if the shares have increased in value in the interim.

The original proposals also:

- contained transitional rules for existing ESS arrangements;
- allowed a deduction to employers for the cost of shares issued under an ESS;
- deferred the taxation point for start-up company ESS benefits to when the shares are sold or listed; and
- included additional employer reporting on ESS benefits.

Key Points – Updates to the Proposals

While there has been nothing new of substance added in the updated proposals, some additional detail has been provided on how the new rules for taxing ESSs would apply, which we highlight below.

1. ESS Benefit Dependent on Continued Employment

The updates confirm that ESS benefits, which depend on continued employment, should be taxed once that employment has occurred (i.e., the relevant employment conditions have been satisfied).

KPMG NOTE

Inland Revenue maintains that taxation that depends on continued employment is the case with all employee remuneration and benefits. The KPMG International member firm in New Zealand (hereinafter, "KPMG in New Zealand") finds 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 it to be paid back if the employee resigns prior to the end of a restrictive period.

Additional Clarifications to the Above Point

- Taxing point clarification – There is additional clarification that the focus of the taxing point is when the employee has economic ownership of the ESS benefit. An obligation placed on an employee to transfer ESS benefits at market value will not defer the taxing point.
- ESS benefits dependent on future employment – The updates also confirm Inland Revenue's view that ESS benefits (and losses) dependent on future employment are not on "capital account" (i.e., non-taxable). However, the practical result is that winners are taxed but losers do not get a tax deduction.

2. (Share) Options Should Continue to be Taxed When Exercised

Taxing options when exercised was the view in the original proposals, where the award is in the form of a share option, rather than the issue of shares.

KPMG NOTE

This view is supported by KPMG in New Zealand, which has noted that several of its clients have indicated a preference for the taxing point to coincide with the receipt of the benefit – i.e., on conversion to shares – and the ability to fund the tax (e.g., by selling the shares).

3. As Originally Proposed, Employers Will Be Able to Deduct ESS Benefits When Taxable to Employees

The updates also propose applying the same timing and valuation rule where a deduction is currently allowed for ESS benefits (e.g., for payments to parent companies and to trusts for shares).

4. The Tax-Free Status of Widely-Offered Schemes Will Be Retained, but with Some Modifications to the Concession

Currently, ESS benefits provided under certain Inland Revenue approved-schemes (i.e., that are widely-offered to all employees, cap the value of shares provided, and meet certain other requirements) are not taxable. At the time of the original proposals, feedback was sought on whether this concession should be retained, modified, or repealed.

KPMG NOTE

Retention of tax-free status for widely-offered schemes was broadly supported in submissions (including by KPMG in New Zealand). The updates both clarify and tighten the application of this concession.

5. The Transitional Period Has Been Moderately Extended for Certain ESSs Following Consultation

Under the original proposals, the current ESS benefit taxation treatment would continue to apply if (i) the taxing point under the current rules arises before enactment of the new rules and (ii) the taxing point measured under the new rules would be before the end of the third full income tax year following enactment of the new rules. The updates extend this to certain ESS benefits issued *after* the enactment of the new rules (and as a result the taxing point under both the current and new rules would be after enactment). This "grand-parented" tax treatment would apply to ESS benefits granted 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 updates to the proposals.

Timing

Based on the timeframe for submissions on the updates to the proposals, KPMG in New Zealand estimates that draft legislation on the new ESS tax rules is likely to be released around February/March 2017.

KPMG NOTE: Action Steps

The nature of the updates suggest that the core principles for taxing ESS benefits are unlikely to change between now and the release of draft legislation. Employers should therefore be carefully considering the impact of the proposals on their existing ESSs. Please consult with your KPMG or usual tax services professional to assist in evaluating your ESSs against the proposed requirements to determine what, if any, changes may be required.

FOOTNOTES:

1 See the 1 September 2016 news release on the Inland Revenue Web site.

2 See "TaxMail" (a publication of the KPMG International member firm in New Zealand) dated 18 May 2016, for coverage of the earlier proposals.

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RELATED RESOURCE

This article is excerpted, with permission, from "Updated Employee Share Scheme Taxation Proposal," in *TaxMail* (Issue 1, 5 September 2016), a publication of the KPMG International member firm in New Zealand.

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