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Our ref PUB00364 KPMG Submission

8 May 2024

Dear Sir | Madam

KPMG submission – PUB00364: Employee Share Schemes

We welcome the opportunity to comment on the six draft items (five interpretation statements and one question we've been asked) concerning the employee share scheme ("ESS") tax regime.

We appreciate the additional time for making our submissions and trust that the points raised may be of use to the Tax Counsel Office ("TCO") in updating and finalising the items.

The draft items consider a wide range of issues. Given the complexity of the ESS regime and number of issues presented this guidance is extremely valuable for taxpayers. The approach of dividing the guidance into separate items is also sensible.

We have set out in the **Appendix** to this letter our submissions on each item.

Our submissions focus on specific issues we consider warrant further consideration. We have not attempted to comprehensively comment on all aspects given the wide range of matters covered, and we have not commented on all items.

Further information

Please do not hesitate to contact Robert, on (09) 304 5295, should you wish to discuss this submission in greater detail.

Yours sincerely

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Partner

Robert Grignon
Director

APPENDIX

PUB00364/A: What an employee share scheme is, the taxing date and apportionment

This draft interpretation statement addresses a number of issues in relation to the scope of the ESS rules, when the share scheme taxing date ("SSTD") arises in various situations, and application of the apportionment provisions in s CE 2(5) of the Income Tax Act 2007 (the "Act").

Our submissions on this item are set out below.

1. Who is an "employee" for purposes of the ESS rules should be addressed

The item goes into detail on many aspects of the ESS rules, including observing that "an employee includes a person who will be, is or has been an employee or shareholder-employee of the company".[1] However it does not address how "employee" is defined for purposes of the rules. A reader of the item may assume that an "employee" has its ordinary meaning under employment law concepts given there is no indication that "employee" is a broader concept in the ESS rules (i.e., the scope of the ESS rules is arguably understated in the item).

For the purposes of the ESS rules, an "employee" includes a person who receives or is entitled to receive a PAYE income payment (section YA 1 definition of "employee"). A PAYE income payment is defined in s RD 3 to include a schedular payment, as defined in s RD 8, that is, a payment subject to withholding because it is of a class set out in Schedule 4 of the Act.

The class of payments within the scope of the schedular payments rules is broad, and applies to a number of persons who are not "employees" in an employment law sense, e.g., independent contractors and non-executive directors. This includes NZ resident independent contractors who have voluntarily elected to have tax withheld under the schedular payments rules (Part W of Schedule 4).

In the case of non-residents, whether or not the schedular payment rules apply (and hence whether a person is potentially in the scope of the ESS rules) can be very complicated – see for example *IS 19/01: Income tax – application of schedular payment rules to non-resident directors' fees.* This includes, among other things, consideration of who are the contracting parties, application of relevant DTAs, and exclusions in s RD 8(1)(b) from the schedular payment definition (e.g., 92-day count test for physical presence in NZ, the $15,000 *de minimis* exclusion, and non-residents who have obtained an exemption certificate from Inland Revenue).

In our experience, it is not uncommon for resident and non-resident directors (who are not otherwise employed by the company) to participate in a company's ESS.[2] We have also seen examples of independent contractors (e.g., consultants and brand ambassadors) who are offered participation in a company's ESS. It can be complicated in practice to determine whether the

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[1] At para [5]
[2] In particular it is not uncommon in certain industries, e.g. tech start-ups, to provide remuneration in the form of equity/ share options to non-executive directors.

ESS rules apply to such individuals. While the outcome of this can be somewhat arbitrary due to differences in DTAs, exclusions, etc (raising policy questions outside the scope of this guidance), we consider the Commissioner should at a minimum address the scope of the "employee" definition for purposes of the ESS rules to alert readers to this issue.[3]

Lastly, we note this issue may also have implications for the other items which TCO may wish to comment on. For example, PUB00364/B deals with deductions for the employer under s DV 27(6). The deemed expenditure under that provision will only apply to the extent participants are "employees" within the scope of the ESS rules.[4]

2. Conclusion as to when shares are "held" by person may create practical issues

The item concludes that shares must exist to be "held" by a person for the introductory wording of s CE 7B(1)(a) to be met. Shares will not be "held by" a person until the person has legal ownership and is recorded on the share register (or the shares are legally held by another person "for the benefit of" the ESS beneficiary).

Practically, this can mean different tax outcomes can arise depending on whether shares are in existence or not on the relevant 'trigger' date (e.g., on vesting date or exercise date, depending on the terms of the scheme).

Considering share options for example, IR commentary suggest that the 2018 changes to the ESS rules were not intended to change the taxing date for "straight-forward" employee share options, and that the employee will continue to be taxed when the options are exercised.[5] However if the scheme involves the company issuing *new* shares when options are exercised (rather than allocating pre-existing shares to the employee), then the exercise date will *not* be the SSTD. Rather, the SSTD will be deferred until such time as the shares are actually issued. Hypothetically, if the share price is volatile there could be a material difference in tax outcomes due to differing values on exercise date and the date the shares are issued and the person is legally entered on the share register.

We acknowledge this is more of a tax policy issue than an interpretive matter, however we would encourage TCO to consider and address these practical concerns in the item. This is particularly important given "straight-forward" options may not be taxed on exercise in all cases, as suggested in IR commentary. Given outcomes may differ from previous IR commentary, we consider this aspect of the interpretation statement should apply prospectively in accordance with *Status of Commissioner's advice (December 2012)* (similar to how PUB00364/D is proposed to apply in relation to cash-settled ESS benefits).

We also recommend this issue is referred to Inland Revenue Policy and Regulatory Stewardship for consideration of a possible legislative change. In terms of practical implications, the current position creates challenges for employers in terms of meeting their reporting obligations. Payroll

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[3] Consideration should be given to cross-referencing other guidance (e.g. IS 19/01) which may be relevant to determining whether the ESS rules apply to a particular person participating in the scheme.
[4] We note that deductions may be available for expenditure under other provisions for non-'employees' in certain circumstances, e.g. options cancellation payments may constitute deductible expenditure under s DA 1(1) when paid to non-'employees', depending on the facts and circumstances.
[5] See e.g. *Special Report on Employee Share Schemes*, Policy and Strategy, Inland Revenue (May 2018), at page 9.

teams will be required to seek further information about when the employee becomes the recorded owner of the shares on the share registrar, rather than relying on the exercise date which is typically captured through internal share programmes. Whether shares are being newly issued or already in existence also makes it difficult for taxpayers and their advisors to clearly identify the taxing date and there does not appear to be any principled basis for these distinctions. Given our understanding that IR has identified lack of compliance with the ESS rules being an issue (which may be explained in part by the complexity of the rules), the issues discussed add further complexity to an already challenging regime, which payroll teams may be ill equipped to manage (and without compelling policy justification).

3. Examples should be updated to reflect TCO's adjudication decision in TDS 24/08

In the adjudication decision summarised in TDS 24/08[6], an employee was granted rights to receive ordinary shares in an employer company which vested around three years after grant date. The employee then had until the end of the second fiscal year following the year in which the rights vested to exercise the rights.

The employer company and IR Customer and Compliance Services took the position that the SSTD was when the rights were exercised. However, TCO agreed with the employee in adjudication, concluding that the SSTD was when the rights vested, rather than on exercise. The conclusion is premised on the fact that the shares were "held for the benefit of" the employee as at the vesting date, and there was no material risk that the employee's beneficial ownership of the shares would change.

This conclusion appears consistent with the conclusions in the draft IS. However, similar to our submission point 2 above, it further illustrates practical issues with the fact that shares must be in existence for them to be "held" by or for the benefit of the employee to have a SSTD.

In TDS 24/08, the shares were already in existence, being held by the company as treasury shares. On exactly the same facts, if the company had instead agreed to issue new shares on exercise rather than allocating treasury shares to the employee, the conclusion would (presumably) be that the SSTD would arise after exercise (once the shares were issued and the share register was updated), as opposed to on the vesting date.

From the employee's point of view, there appears to be little (if any) distinction between these scenarios. But it would significantly change the tax outcome, both for the employee and the employer. Again, this appears to be a tax policy issue rather than a technical interpretation matter.[7]

Given the unintuitive outcome, we consider the draft item should be updated to clearly bring this distinction to the attention of readers. We recommend that an example based on the facts of

[6] *TDS 24/08: Employee Share Scheme – right to receive shares*, Inland Revenue (April 2024)
[7] What if the company did not have sufficient treasury stock to allocate to the employee, so the shares the employee received post-exercise were a mixture of treasury stock and newly issued shares? It would appear there are two different SSTDs (treasury shares SSTD is on vesting, but new shares SSTD is post-exercise once shares are issued and share register updated), arising in different income years, and potentially with materially different amounts of tax payable. This is despite the employee being completely indifferent as to the source of the shares.

TDS 24/08 should also be included, along with an alternative scenario where the company issues new shares on exercise rather than allocating treasury shares (all other facts being the same).

4. Apportionment formula and non-resident directors

As previously noted, non-resident directors may be "employees" for purposes of the ESS rules if they receive schedular payments.

Paragraphs [69] to [77] of the item discuss the application of the apportionment formula in s CE 2(5) and (6). The intention behind this provision is to ensure that a portion of the ESS benefit that accrues while an employee is non-resident is not taxed in New Zealand, only the proportion that accrues while they are New Zealand resident and earning NZ-sourced income should be taxable.

When applied to non-resident directors who are "employees" for purposes of the ESS rules, it is apparent that the apportionment calculation does not apply and the full benefit is prima facie taxable. In order for a period of ESS benefit accrual to be non-taxable under the apportionment calculation, it must qualify as an "offshore period" as defined in s CE 2(6). This definition requires that the person is not resident in New Zealand and that any services they perform for the relevant employer gives rise to an amount of income that is a foreign-sourced amount.

While a non-resident director of a New Zealand company will satisfy the first limb, IS 19/01 confirms the Commissioner's view that directors' fees paid to a non-resident director will *always* have a New Zealand source, i.e., will never be a "foreign-sourced amount". Accordingly, the apportionment formula is s CE 2(5) can never apply to exempt ESS income from New Zealand tax for a non-resident director.

This outcome appears consistent with the policy position that, absent DTA relief or other exclusions applying, New Zealand asserts taxing rights over remuneration paid by New Zealand companies to non-resident directors. This remains true whether the remuneration is in the form of cash or shares under an ESS.

Assuming TCO agrees with this analysis, we recommend the discussion of the apportionment formula in the item be updated to note these provisions will not apply to relieve non-resident directors from tax under the ESS rules (assuming the ESS rules otherwise apply to the director).

PUB00364/B: Deductions for parties to employee share schemes

This draft interpretation statement addresses questions about an employer's expenditure or loss under s DV 27(6), including a discussion of the capital limitation and *Clough Ltd v FC of T (No 2)* 2021 ATC ¶20-805.

We are generally supportive of this item. In our experience, it is a common misconception that s DV 27(6) creates a deemed *deduction* for employers, when in fact the section only creates deemed *expenditure*, with deductibility of that expenditure being subject to the capital limitation. This is most commonly an issue that needs to be considered in the context of liquidity events, e.g., a share sale or initial public offering.

We make the following submissions in relation to this item.

1. We disagree with the conclusion in Example 4 and consider an apportionment approach is required

Examples 4 to 6 apply to the same base facts, with variations to illustrates the Commissioner's view as to when the capital limitation may or may not apply. The examples concern an options scheme, where a pending share sale results in an accelerated vesting event. In all cases the employees received their options as part of their remuneration package for their normal employment duties and they are not involved in the sale process.

In example 4, the Commissioner considers the capital limitation applies to the full amount of the $15,000 option cancellation payment, whereas in examples 5 and 6 the Commissioner considers the capital limitation does not apply and the $10,000 option cancellation payment (example 6) or $10,000 deemed ESS expenditure (example 5) to be fully deductible. We agree with the analysis and conclusions in examples 5 and 6 but disagree that the capital limitation should apply in example 4 to *fully* deny a deduction for the $15,000 of expenditure. We consider an apportionment approach is warranted and that $10,000 of the payment in example 4 should be deductible (the same outcome as in examples 5 and 6) and only $5,000 should be viewed as capital and non-deductible.

In example 4, it is stated that the terms of the SPA require Employer Co to cancel the options and settlement is conditional on that occurring. Under the options scheme, the change in control will constitute a liquidity event. Employer Co offers to cancel the employees' options for a total cash payment of $15,000 ($3 per share based on current market value), but if they do not accept the offer, their options will automatically vest and they will receive a cash payments totalling $10,000 ($2 per share under terms of the option plan) instead of shares. The Commissioner considers the entire $15,000 cash payment is capital in nature primarily because the purpose of the payment is to effect the sale of shares, and the SPA requires cancellation of the option plan and is conditional on that occurring.

In examples 5 and 6, the proposed sale similarly triggers a liquidity event with accelerated vesting of options. In example 5, the employees exercise their options, acquiring shares for $5,000 ($1 per share exercise price) which are immediately sold to the purchaser for $15,000 ($3 per share market value), resulting in $10,000 of ESS income and $10,000 of deemed expenditure for Employer Co. In example 6, the employees do not exercise but are instead offered cash payments totalling $10,000 ($2 per share under terms of the option plan) to cancel their options which they accept, resulting in $10,000 of ESS income and $10,000 of expenditure for Employer Co. If they did not accept, then the outcome would have been identical to example 5 (i.e. they exercise at $5,000 and sell to purchaser for $15,000 resulting in $10,000 of ESS income and deemed expenditure for Employer Co). In both examples 5 and 6, the Commissioner considers the whole of the $10,000 expenditure is deductible for Employer Co, as the capital limitation does not apply.

In support of deductibility in examples 5 and 6, the Commissioner notes that the sale triggers an early vesting of the options; this obligation existed before the sale of Employer Co's shares; the option plan incentivises employees to stay employed for Employer Co for at least 3 years (or until a liquidity event occurs); and the SPA's requirement that Employer Co must cancel any unvested options on settlement does not change the outcome, because the options will vest due to the liquidity event (and lapse if not exercised) irrespective of the SPA obligation.

We consider these statements are also generally true in relation to example 4, as relevant to the capital/revenue analysis.

In all three scenarios, there is accelerated vesting of options and employees will receive a benefit of <u>at least</u> $10,000 regardless of what steps are taken. In examples 5 and 6, the employees will only ever get a $10,000 benefit. However, in example 4, they are offered an additional $5,000 cash payment to secure the cancellation outcome. But as stated in example 4, if they did not accept, they would receive a $10,000 cash payment under the terms of the options plan instead of shares. They will *always* receive at least $10,000, which in our view is the amount they are being compensated as part of their ordinary remuneration arrangements, for the same reasons as in examples 5 and 6.

From the purchaser's point of view, under either alternative in example 4, the purchaser will never be purchasing shares from the employees (who will never become shareholders). Their goal of ensuring the option plan is "wound up" and there are not additional parties to the SPA will be achieved either way. We consider example 4 is artificial to the extent it assumes a reasonable purchaser would not accept vesting and $10,000 cash out for options holders (as is required under the terms of the options scheme), and that the purchaser would only proceed with the transaction if the options never 'technically' vest, being the reason Employer Co is offering to cash out the options at $15,000 in this example.

In our view, $10,000 of the payment (ESS benefit) should be deductible in all scenarios for the reasons the Commissioner sets out in examples 5 and 6. We do agree insofar as the additional $5,000 paid to the employees in example 4 to secure cancellation without vesting is likely to be capital in nature, as this portion of the expenditure would not have arisen but for the sale transaction.

It is acknowledged in the item that an apportionment approach may be required in some cases. At paragraph [64], the item states:

> The amount of the employer's deductions may be different to the amount of the employee's assessable income because the employer's expenditure or loss under s DV 27(6) is subject to the general permission and general limitations. This may result **in apportionment** or denial of a deduction. (*bold emphasis added*)

In IS 14/04, the Commissioner summarised the following principles of apportionment based on case law as relevant to deductible expenditure:

- Apportionment issues arise because expenditure is deductible under s DA 1 "to the extent to which" it is incurred in deriving income: ***Banks***.
- Apportionment encompasses situations where undivided items of expenditure can either be dissected or not: ***Banks; Ronpibon Tin***.
  - Dissection can apply where the expenditure relates to distinct and severable parts divisible between those parts that give rise to deductible expenditure and those parts that do not.

  - Where the expenditure serves both deductible and non-deductible objects at the same time, dissection may not be possible and a fair and reasonable assessment must be made of the extent of the relationship between the expenditure and deductible objects.

- Apportionment is not required where the expenditure has some incidental non-deductible object and the true character of the expenditure remains deductible: ***Buckley & Young; Christchurch Press***.

- The most appropriate way of apportioning expenditure depends on the circumstances of the case but practical difficulties alone in determining how apportionment should apply does not mean apportionment should not be made: ***Buckley & Young***.[8]

Applying these principles to example 4, we consider the appropriate outcome should be to apportion the expenditure, such that $10,000 of the payment is deductible (it relates to the employees' regular employment, the obligation existed prior to the sale transaction, and they were already entitled to receive $10,000 at a minimum) and $5,000 of the payment is non-deductible (additional expenditure arises only due to the share transaction with no pre-existing entitlement for employees, and, at least on these facts, no requirement that they remain employed post-transaction).

While we appreciate apportionment will be dependent on the facts of each case (and the onus is on the taxpayer to establish the extent of any apportionment), we consider there are sufficient facts available to establish this apportionment in example 4. From a policy point of view, we also consider the subtle distinction in facts in these examples (between examples 4 and 6 in particular), does not justify completely opposite outcomes. The employees will enjoy a benefit of at least $10,000 under *any* of the scenarios in each example.

We consider the conclusions in example 4 should be revised accordingly, and that the item should include a general discussion of when apportionment may be appropriate (e.g., incorporating similar comments as in IS 14/04).

2. Additional examples and clarification required

All examples in the draft item assume employees are not involved in the sale process. However, we consider it would be helpful for taxpayers to have clarity on IR's views on the situation where the individuals are involved in the sale process, given certain ESS beneficiaries (e.g., CEOs and CFOs) often have some degree of involvement.

In our experience, it is generally the case that such persons may have been granted shares or options in the ordinary course of business (remunerating these employees for their regular services, providing retention incentives, etc.), without regards to the transaction. We consider the capital limitation should generally not apply in these circumstances, regardless of whether the liquidity event accelerates vesting (which is a common feature in ESSs).

In our view it is typically only where the employee is receiving some additional value/benefit, which they would not have been entitled to but for their work on the transaction, that may raise

[8] *IS 14/04: Income Tax: Deductibility of Company Administration Costs*, Inland Revenue (June 2014), at [42].

questions as to deductibility. And in such circumstances, we consider an apportionment approach may be required, similar to our views on example 4 discussed above.

Given liquidity events often trigger vesting (and in some cases, are the sole trigger) under ESSs, it would be helpful for TCO to expand on their views on this topic. The current examples appear to have deliberately avoided this issue.

PUB00364/D: Employee share scheme benefits paid in cash – PAYE and KiwiSaver obligations

This draft interpretation statement addresses questions about whether an employer has PAYE, ACC and/or KiwiSaver obligations for an ESS benefit that is paid in cash instead of shares, regardless of whether the employer has made an election to apply PAYE to the ESS benefits.

1. Prospective application of the interpretation in the item

The item concludes that a cash-settled ESS benefit is an "extra pay" under the general definition of extra pay, regardless of whether an election to withhold PAYE has been made. The item notes that a cash-settled ESS benefit was already an "extra pay" under the definition of extra pay prior to the amendments to the ESS rules in 2018 and this was not impacted (and not intended to be impacted) by the introduction of s RD 7B which sets out how an employer makes an election to withhold tax from an ESS benefit. While s RD 7B refers to "benefits under an employee share scheme" generally, the effect of the interpretation is to read s RD 7B as applying to share-settled benefits only, as cash-settled benefits are already an "extra pay" (it is therefore not possible to read s RD 7B as applying to cash-settled ESS benefits).

The item acknowledges that this conclusion is inconsistent with previous guidance from Inland Revenue, which suggests that the election to withhold PAYE applies to *all* ESS benefits (which is suggested by the wording of s RD 7B, in isolation), whether cash- or share-settled.

In our experience, this conclusion is also inconsistent with Inland Revenue practice where, at least in some cases, Inland Revenue has accepted the election in s RD 7B as applying to cash-settled benefits.

Given this, it is stated in the item that Inland Revenue proposes this interpretation statement will apply prospectively to cash-settled ESS benefits in accordance with the *Status of Commissioner's advice (December 2012)*.

We strongly support this item being applied on a prospective basis only, given the interpretation statement's inconsistency with previously guidance and Inland Revenue practice.

However, the item needs to more explicitly address how this will be applied. For example, in *Status of Commissioner's advice*, the Commissioner states that where an incorrect public statement is replaced by a new published public statement that is less favourable to taxpayers, the new statement will explicitly state the date from which it will apply (or in exceptional cases, that it applies to prior periods). We consider the draft item should be viewed as being "less favourable" to taxpayers, as it removes the 'optionality' suggested by previous guidance and exposes employers to non-compliance with PAYE withholding obligations on cash-settled benefits (where they previously believed PAYE to only apply if they elected for it to do so).

Assuming there is no change in interpretation, we consider the final statements should be explicit that it applies prospectively from the date the final item is published (rather than, for example, the date the draft item was released).

Additionally, we note that some employers and employees may have already entered into legally binding arrangements under which the parties have agreed (or acknowledged) that PAYE will not be withheld from any ESS benefits under the scheme, whether ultimately share- or cash-settled. They may have agreed this position based on Inland Revenue's previous guidance or agreed practice. It may be challenging in some cases for the parties to amend (or renegotiate) the legal arrangements in light of the employer's PAYE withholding obligations as set out in the draft item.

For this reason, we consider there should be a reasonable "grandparenting" period, where the Commissioner will not devote resources to challenging positions where PAYE is not withheld from cash-settled ESS benefits, to the extent there is already an ESS scheme in place (prior to publication of the item) under which the parties have agreed the employer will not withhold PAYE from cash-settled benefits.

Finally, we consider the item should clearly state that if a taxpayer has obtained a binding ruling which is contrary to the conclusions in the item, the binding ruling shall remain binding on the Commissioner (for the period stated in the ruling) despite the change in interpretation. While this is covered in *Status of Commissioner's advice*, we consider this is worth noting in the item given the potential importance to affected taxpayers.

PUB00364/F: Fringe benefit tax – employee share loans and associates

This draft QWBA addresses the question of whether a fringe benefit arises where a trustee of a family trust ("Trustee") that is associated with an employee is provided a loan to acquire shares under an ESS.

The item concludes that where the loan is provided to a Trustee that is an associate of the employee, a nil or below-market interest rate on the loan will not give rise to a fringe benefit if the Trustee meets all employee share loan criteria in s CX 35, reading all references to the "employee" in that section as instead referring to the Trustee.

To reach this conclusion, the Commissioner relies on s GB 32, a specific anti-avoidance provision which deems benefits provided to an associate of an employee to have been provided to the employee. In the Commissioner's view, this provision and the commentary in *Public Information Bulletin* Part 1, Number 136 (May 1985) supports the reading that all references to the employee in s CX 35 should be read as being references to the associated person (i.e. the Trustee).

While we support the outcome of this analysis, we consider there are a number of additional issues this raises which should be addressed in the item.

1. Consideration should be given to the scope of the item

The conclusion reached in the item means that a fringe benefit should not arise where *any* associate of the employee (within the scope of s GB 32) meets the criteria in s CX 35.

While the ‘Question We’ve Been Asked’ relates to the Trustee of a family trust only, we consider the item should address the wider implication that that the same conclusion should apply where, for example, the employee’s spouse, civil union partner or de facto partner beneficially owns the shares and meets the other criteria in s CX 35. We note this is already implied by the draft QWBA’s title and the explanatory text at the start of the item (which refers to an “associate of the employee” rather than specifically to the Trustee of a family trust).

2. The Commissioner should provide guidance on FBT refund requests

We are aware that some taxpayers have taken the position that s CX 35 does not apply if the employee is not the beneficial owner of the shares (e.g., where the shares are held by the trustee of their family trust), based on the plain wording of s CX 35(1)(c) without the s GB 32 overlay. Accordingly, in some cases FBT will have historically been paid on nil or low-interest loans to family trusts that should be exempt from FBT per the conclusions in this item.

We expect that companies that have erroneously paid FBT on these loans may seek refunds pursuant to s 113 of the Tax Administration Act 1994. Given the Commissioner’s views expressed in the item, we consider it is appropriate administrative practice for the Commissioner to exercise his discretion to amend assessments and refund FBT in these circumstances.

It would be useful for taxpayers if the Commissioner provided guidance on this point, whether in the item or by issuing an Operational Position on how the item will be applied where taxpayers have taken inconsistent positions.