TO: IRD

ON: TAXATION OF EMPLOYEE SHARE SCHEMES

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INTRODUCTION

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ABOUT CHAPMAN TRIPP

3 Chapman Tripp is a full service corporate law firm with offices in Auckland, Wellington and Christchurch.

Thank you for the opportunity to comment on the officials’ issues paper “Taxation of employee share schemes” (the Issues Paper).
SUMMARY OF MAIN ISSUES

4 We agree that tax rules should not be an obstacle to the use of ESS. We are concerned that some schemes have become overly complicated, making both the schemes and the tax treatment of them difficult for participants to understand. In addition, the recent uncertainty of tax treatment of ESS is undesirable. We support clarification and simplification of the tax rules applying to ESS and the removal of incentives for tax considerations to be overly influential in the choice of scheme design.

5 We are broadly supportive of the approach the Issues Paper takes in respect of seeking tax-neutrality for arrangements providing similar economic outcomes. We agree that ESS designed to operate as option-like schemes should be taxed in the same manner as option schemes.

6 However, we are concerned that the Issues Paper takes too simplistic an approach in assuming cash remuneration and ESS should be taxed in a consistent manner. It appears that the Issues Paper treats gains on shares as relating to employment (i.e. as employee remuneration) in cases where it could be more appropriate to regard those gains as arising as a result of being a shareholder. We discuss this in more detail below, but the point can be illustrated by the following examples.

(a) We understand Inland Revenue takes the view that no taxable income would arise where shares are issued to an employee for market value and the employee is required to dispose of those shares (at market value) on leaving employment. In that case, any gains made do not relate to employment.

(b) This example can be compared with one where shares are issued to an employee but held on trust, with vesting occurring in three years’ time if the employee remains in employment at that time. In the absence of any other features providing downside protection to the employee, we do not see this example as materially different to the above example. It is likely that the commercial drivers for requiring an employee to remain in employment are the same in both examples, with a focus on employee engagement, long term alignment of
interests and, for closely held companies, a concern to limit who can hold shares. In those circumstances, gains (or losses) on the shares after issue date should also be regarded as not relating to employment and instead arise by virtue of being a shareholder.

7 For the reasons discussed below, we consider there remains a place for widely offered schemes.

8 As a final general comment, the design of any new rules for ESS should take into account the impact on existing schemes and compliance costs. While we support simplification of the rules, this should be balanced against what we assume will be relatively modest additional tax raised (in light of the deduction proposed to be provided to employers).

9 We have concerns with some aspects of the framework set out in section 2 (and elsewhere) of the Issues Paper.

(a) The Issues Paper appears to assume that ESS are simply a form of employee remuneration and substitutable for cash remuneration. This does not recognise that ESS can, and often do, have the further purpose of enabling employees to participate as shareholders in the business. This encourages employees to become more engaged in wider aspects of business performance, encourages an interest in the company’s share price and provides opportunities for employees with low net wealth to own shares. It also encourages greater interest in financial matters, the operation of financial markets and deepening financial literacy. None of these benefits can be provided by a cash bonus scheme.

(b) Aligned with this, it is not necessarily the case that conditional share schemes are designed to deliver tax free remuneration to employees. Conditions may have more to do with retention and/or otherwise encouraging long term holding of shares and engagement with the employer. We discuss this further below in relation to the proposed treatment of conditional share schemes.
(c) We agree with comments at paragraphs 2.22 and 2.23 of the Issues Paper, particularly that it is important to correctly determine the nature of income. However, the Issues Paper appears to assume that all gains on shares received under an ESS must be employee remuneration if they arise before shares vest. Example 2 on page 9 of the Issues Paper states that it “clearly would not be appropriate” for an employee not to be taxed on an increase in share value between the time shares are promised to an employee and when the shares are provided one year later. It is not clear to us why it necessarily follows that the increase in share price should be treated as employee remuneration, rather than as a return enjoyed as a shareholder.

(d) The Issues Paper focuses largely on the outcome for the employee when considering the consistency and neutrality of different forms of remuneration and appears to give only brief consideration to the position of the employer. While recognising in paragraph 3.5 that employers incur an implicit cash wage cost when issuing shares, that cost does not appear to be factored into analysis elsewhere in the Issues Paper comparing the economic outcomes from cash remuneration and ESS. For example, the cost of issuing shares today will not be the same as the cost of issuing shares at some future point (the latter being an uncertain amount, which may not be commercially acceptable to an employer).

(e) The comparison of the after-tax value of options in section 4 of the Issues Paper appears to assume a withholding tax in the case of “tax at issue” (with the number of options held reducing accordingly). However, until recently it has not been possible for employers to withhold tax and, going forward, employers may choose to withhold but are not required to do so. Where tax is not withheld, an employee would need to meet the tax liability from other resources and the number of options held would not be reduced. The outcome in Example 3 would then differ; the pre-tax benefit would be
$50, tax paid of $8.25 and an after-tax value of $41.50 rather than $33.50 as shown in the Issues Paper. The conclusion in the Issues Paper that the outcome is the same regardless of whether options are taxed at issue or at exercise does not appear correct to us. This may warrant reconsideration of some of the proposals in the Issues Paper.

**CONDITIONAL AND OPTION-LIKE SCHEMES**

10 In line with our comments above, we broadly agree with the proposals to align the treatment of option-like schemes with the tax treatment of options. We also agree that it is appropriate to address conditional schemes designed to deliver tax free remuneration to employees, for example where performance hurdles are set in such a way that the employee will either receive shares that have increased in value or will forfeit the shares without any cost to the employee.

11 However, we don’t see a compelling rationale for taxing movements in share price between issue date and vesting in cases where a conditional scheme is not designed to deliver tax free remuneration. Broadly, this could be described as schemes where the ESS participant is exposed to both gains and losses on the shares. In those cases, we consider movements in share price after the date of issue should be regarded as arising from the shareholder relationship, not employment relationship.

12 An example of a conditional scheme that should, in our view, be subject to tax on issue is an ESS where the only condition is tenure. Such a condition does not provide downside protection to employees. Employees may make gains, losses or neither, just as other shareholders do, over the vesting period. Taxing on vesting because that is when deferred cash bonuses are taxed is not robust reasoning in our view. Cash bonuses do not deliver shares and do not have the same purpose as share schemes. In addition, it is possible for cash remuneration to be paid now but subject to a condition that it be repaid in the future (e.g. sign-on bonuses that must be repaid if the employee leaves before a certain date, or study leave that must be repaid if an employee fails to obtain the relevant qualifications). In those cases, tax would be paid when received and not after the expiry of the relevant period. Finally, there is a clear (non-tax)
benefit for employers in being able to specify a dollar value and certain number of shares today rather than adjusting the number of shares issued later based on the share price at the time. Employees are then not indifferent to share price and performance of the company.

13 A distinction should be made between:

(a) an option scheme where the option is exercisable at today’s market value in, say, 3 years time if still in employment (with no other conditions or performance hurdles); and

(b) a conditional share scheme with shares issued today and vesting subject only to the employee remaining in employment in 3 years time.

14 The two schemes are not the same and provide a different economic outcome. If acting logically, the employee would not exercise the option if the share price has fallen at the end of 3 years. However, with the share scheme, the employee will have no choice but to suffer the reduction in value (assuming it cannot sensibly be asserted that the employee might choose to resign to prevent the shares from vesting). This justifies a different tax treatment of the two schemes.

15 There are likely to be other conditional ESS that are not designed to provide tax free gains to employees. We submit that further consideration should be given to identifying schemes where the nature of the benefit is income from employment and those where the nature of the benefit is an exposure to movements in value on shares in a capacity of shareholder.

NON-RECOURSE LOANS 16 The Issues Paper refers to non-recourse loans as an example of a situation where an employee is protected against a loss due to a decline in share price. In our view, a non-recourse loan should not be sufficient in itself to justify deferral of income recognition. The reason for our view is that taxable income from debt remission is likely to arise to an employee in the event that the loan is not repaid. As such, the economic benefit that is provided to the employee, being the downside protection, is taxed.
Example 4 in the appendix to the Issues Paper considers the treatment of a share scheme with partial debt remission. It is said that imposing tax on the debt remitted has the result that “the correct amount of tax is paid, but in the wrong circumstance”. We disagree. When compared with an ESS that involves a full-recourse loan but otherwise is on the same terms, the benefit provided to the employee is the non-recourse nature of the loan. Taxing debt remission appropriately taxes the benefit provided.

We agree with the proposal to allow a deduction to employers for the benefit provided under ESS.

We agree that there are issues with the current provisions dealing with widely offered schemes. We consider that there are good reasons to maintain a regime for widely offered schemes and strongly support changes to the existing regime to address the current issues and make the regime more workable.

We disagree with the comment in the Issues Paper that the concessionary nature of the existing regime undermines fairness, tax neutrality and economic efficiency. We consider that this does not give sufficient weight to benefits widely held schemes provide, such as encouraging share ownership by people who otherwise would not participate in our capital markets, greater engagement with company performance and increased financial literacy.

Maintaining a regime for widely offered schemes is also consistent with the Government’s Business Growth Agenda (BGA) and its efforts to lift productivity and competitiveness. It seems counter-intuitive to repeal the widely offered scheme regime following changes to reduce compliance costs for businesses offering employee share schemes prompted by the BGA 2014 Future Direction report.

We submit that an appropriate way forward for widely offered schemes would be to amend aspects of the regime that have become out of date or prevent employers from using the regime. For example:
(a) the current $2,340 limit should be increased to a more appropriate level, perhaps to $15,000 over a 3 year period

(b) it seems appropriate to have an upper limit on exempt benefits to prevent largely unrestricted tax-free benefits being provided under the scheme, and

(c) the deemed interest deduction to the employer should not be required if the proposal to allow employers a deduction more generally for ESS is implemented.

VALUATION SAFE HARBOUR

23 The Issues Paper notes that valuation issues can arise in relation to start-up companies. This is also a potential issue for other companies, including listed companies. Even in widely held liquid securities, the share price in any week can move up or down 1% through market trading. In smaller cap. stocks, trading can be more volatile.

24 It would be helpful if the legislation provided a "safe haven" method or methods for calculation of market value for purposes of ESS. For example, for listed companies the legislation could provide that use of end of day, or a volume weighted share price over a period, would be accepted as the market value.