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## WEEKLY COMMENT: FRIDAY 24 APRIL 2015

1. This week and next week I look at the proposals for changes in *Simplifying the collection of tax on employee share schemes – An officials' issues paper* (“the Share Schemes Issues Paper”) released on 1 April. The proposals apparently have resulted because officials have been advised of difficulties faced by employers and employees in accounting for tax on benefits provided under “share scheme agreements” – otherwise known as “employee share schemes”.
2. It is stated that the Share Schemes Issues Paper relates only to non-monetary employee share benefits. Therefore, I feel it is appropriate to first put non-monetary employee share benefits in context and look at the available alternative methods whereby employees may benefit from employee share schemes. This week I look at the tax implications of employee share schemes under current rules. Next week I will look at the proposals for change.

### **Income of a person in connection with their employment**

3. Amounts derived by a person in connection with their employment or service that are income of a person are set out in s. CE 1(1) of the Income Tax Act 2007 (“the Act”). They include, under s. CE 1(1)(d), “a benefit received under a share purchase agreement”.
4. A “share purchase agreement” is defined in s. CE 7 as meaning “an agreement to sell or issue shares in a company to an employee that is entered into in connection with the employee’s employment or service, whether or not an employment relationship exists when the employee receives a benefit under the agreement”.

### **Value of the benefit**

5. The “benefit” received, assuming no restrictions on disposal apply, is covered in s. CE 2 as follows.
6. **When the employee acquires the shares** (s. CE 2(2) and s. CE 6): If an employee acquires shares under a share purchase agreement, the value of the benefit to the employee is the amount by which the value of the shares when they were acquired is more than the amount paid or payable for them. The employee receives the benefit in the income year in which they acquire the shares, and for this purpose:
  - (a) Shares are treated as having been acquired on the date on which the right or option to buy them is exercised (i.e. no employment income results from the issue of options – which has implications for transitional residents who received options as a transitional resident - see paragraph 17 below, and New Zealand residents who received options before coming to New Zealand); and

(b) If shares or rights are acquired or transferred under an agreement by a trustee for the benefit of an employee, the employee is treated as having acquired or transferred the shares or rights. (Note: this particular rule implies that the employee must be an identifiable individual.)

7. **When the employee disposes of rights to acquire the shares to a non-associated person** (s. CE 2(3), s. CE 2(5) and s. CE 2(8)): If an employee, either directly or through one or more associated persons, disposes of their rights under a share purchase agreement (note the reference to “rights” which means, for example, an option to acquire shares, and includes the cancellation of a share option in return for a cash payment) to a person who is not associated with them, the value of the benefit is the consideration for the disposal of the rights. The employee receives the benefit in the income year in which they, or the last associated person, dispose of the rights.
8. **When an associate of the employee acquires the shares** (s. CE 2(4)): If, following 1 or more transactions between associated persons, an associated person acquires the shares under a share purchase agreement, the value of the benefit is the difference between the value of the shares on the date of acquisition by the associated person and the amount paid or payable for them. If the difference is negative, the value is zero. The employee receives the benefit in the income year in which the associated person acquires the shares.
9. There can be difficult valuation issues that arise in the case of private companies, for example, where an employee acquires shares at an issue price that was struck some time earlier.

#### **Effect on value of restrictions on disposal**

10. The value of the benefit can be adjusted downwards if there are restrictions on disposal as set out in s. CE 3.
11. The first restriction is one that applies for at least 8 years after the end of the tax year in which the employee receives the benefit or, if earlier, until the date of the employee’s death.
12. The second restriction is one that applies for at least 8 years after the end of the tax year in which the employee receives the benefit or, if earlier, until the date of the employee’s death and provides that if an employee ends their employment or service before the end of the period, the employee must unconditionally transfer some or all of the shares to the employer or to the person from whom the employee acquired them, either without consideration or for a consideration that is no more than that paid by the employee.
13. If a share purchase agreement does not restrict an employee from transferring the shares under a relationship agreement, restrictions can be taken into account to reduce the benefit if they apply to the transferee as if the transferee were the employee.

#### **Benefit received while a transitional resident**

14. There is a reduced benefit if the employee acquires shares or disposes of rights while a transitional resident.
15. A transitional resident is taxable on worldwide income to the extent that it is either “employment income of a type described in s. CE 1 in connection with employment or service performed while the person is a transitional resident” or “income from a supply of services”. The exemption in s. CW 27 for foreign-sourced income derived by a transitional resident does not extend to employment income or income from a supply of services.

16. Therefore, a transitional resident is, prima facie, taxable on “a benefit received under a share purchase agreement”. However, under s. CE 2(9) the benefit received by a transitional resident is reduced by the proportion of time employed as a non-resident to the total time employed while a non-resident and a resident of NZ.
17. The implication of this rule is that if an option acquired while non-resident is exercised after becoming resident, the benefit received under the share purchase agreement cannot be treated as if it related entirely to the period while non-resident.

### **Provisional tax and UOMI implications**

18. There will be provisional tax implications for an employee who receives a benefit under a share purchase agreement, and there could be use-of-money (“UOMI”) implications.
19. The benefit received under a share purchase agreement is not a PAYE income payment under s. RD 3, because it is not a payment of salary or wages, an extra pay or a schedular payment. Therefore the PAYE rules do not apply.
20. An employee who receives a benefit under a share purchase agreement could, as a result, become a provisional taxpayer under s. RC 3(1) if residual income tax for the year is more than \$2,500, although there would be no obligation to pay provisional tax under s. RC 3(3) if residual income tax for the prior year did not exceed \$2,500.
21. However, if residual income tax is less than \$50,000 for the year and the employee has not estimated residual income tax under s. RC 7, UOMI will not apply under s. 120KE of the *Tax Administration Act 1994* and the residual income tax for the year is due and payable in one instalment on the terminal tax date. Therefore UOMI will not apply unless the benefit under the share purchase agreement gives rise to a residual income tax of \$50,000 or more for the year.

### **FIF tax implications**

22. If the shares are foreign shares, there could be FIF tax implications under the FIF tax regime, unless:
- (a) The shares are in an ASX-listed Australian company exempt from the FIF tax regime under s. EX 31; or
  - (b) The shares are exempt from the FIF tax regime under s. EX 38 because they are shares in a grey list company that directly or indirectly employed the person and there are restrictions on disposal that have not expired for 6 months or more at the beginning of the year.

### **Circumstances where the benefit is zero**

23. There are two circumstances in which the benefit is zero.
24. First, the value of the benefit is zero, under s. CE 2(6), if a share purchase agreement provides unconditionally that, when the employee ends their employment or service or dies, the shares must be transferred to the employer or to the person from whom they were acquired, either without consideration or for a consideration no more than that paid by the employee.
25. Second, the benefit is zero, under s. CE 2(7), if the benefit arises under a share purchase scheme, which is defined in s. YA 1 as meaning a scheme approved by the Commissioner for the purposes of s. DC 12. A share purchase scheme confers an allowable deduction on the

employer for 10% notional interest on loans made by the employer to finance the acquisition of shares under the scheme. The criteria for approval of share purchase schemes are quite detailed and are set out in s. DC 13 and s. DC 14. Three key criteria (there are several others) are that:

- (a) For three years:
  - (i) The cost of the shares cannot exceed \$2,340 in a three-year period;
  - (ii) A trustee must hold the shares for three years (unless employment ends earlier); and
  - (iii) The shares cannot be disposed of;
- (b) All employees must participate equally;
- (c) Directors and persons owning at least 10% of the company are not “employees” for the purposes of a share purchase scheme and are prohibited from participating.

### **Employee share loans**

26. The employer could help fund the acquisition of shares by the employee by providing a loan to the employee or trustee.
27. A fringe benefit arises under s. CX 10 when an employer provides a loan to an employee. For the purposes of this rule, an employee is a person who receives or is entitled to receive a PAYE income payment, which includes schedular payments. Therefore, directors are treated as employees. However, this rule does not apply to a loan made:
- (a) As an employee share loan;
  - (b) Under an employee share scheme (as discussed in paragraph 25 above).
28. An “employee share loan” is defined in s. CX 35 as meaning a loan made to an employee if:
- (a) The loan is made for the sole purpose of enabling the employee to acquire, under a scheme of acquisition, shares, rights, or options in the company that is their employer or in a company associated with the employer; and
  - (b) The employee uses the loan only for the purpose of the acquisition; and
  - (c) The employee beneficially owns the shares, rights, or options throughout the term of the loan; and
  - (d) The employee must immediately repay the loan in full if they stop being the beneficial owner of any of the shares, rights, or options; and
  - (e) The company issuing the shares, rights, or options must maintain a dividend-paying policy throughout the term of the loan.
29. A loan cannot be an employee share loan if:
- (a) The shares, rights or options it relates to are in a qualifying company; or
  - (b) The employer and the employee are associated persons; or
  - (c) The loan is made under a share purchase scheme (which is separately exempt in any case – see paragraphs 27(b) and 25 above).

### **Loans to associates of employees and exceptions for employee trusts**

30. Under s. GB 32, a loan that is provided to a person who is associated with an employee of an employer is treated as being provided to the employee if:
- (a) The benefit would be a fringe benefit if provided to the employee; and
  - (b) The benefit is provided either by the employer or by another person under an arrangement with the employer for providing the benefit; and
  - (c) The exemptions for loans for benefits to companies associated with shareholder employees and benefits by look-through companies to owners or partnerships or limited partnerships to partners do not apply.
31. Therefore, for example, an interest-free loan to a trust established for employees will, prima facie, give rise to a fringe benefit because:
- (a) A trustee is associated, under s. YB 6, with any beneficiary who has benefited or is eligible to benefit;
  - (b) Where a beneficiary is an employee, the trustee will be associated with an employee; and
  - (c) The interest-free loan to the trustee will be treated as provided to an employee.
32. However, under the exception in s. YB 15, the rule of association between a trustee and a beneficiary will not apply and the interest-free loan will not result in a fringe benefit if:
- (a) The trust is only for the benefit of employees (including directors) of the employer; and
  - (b) The beneficiaries (i.e. the directors and other employees) do not control the trust.

### **Funding share acquisitions: loans vs contributions**

33. The employer could help fund the acquisition of shares by the employee by making a contribution to provider of the shares or to the employee share trust.
34. Generally, a contribution to an employee share trust should be tax deductible to the employer on the basis that the contributions are in the nature of employee remuneration. There are a number of English cases that support this conclusion: *Heather (I of T) v P-E Consulting Ltd* (1972) 48 TC 293, *Jeffs (HMIT) v Ringtons Ltd* [1985] BTC 585, *E Betts Ltd v Price (HMIT)* [1987] BTC 49.
35. If the employer pays for the shares, the cost of the shares should be tax deductible on the same basis as above. Equally if the employer compensates a seller of the shares for the market value of the shares, the cost to the employer should be tax-deductible.
36. However, the employer cannot deduct a notional cost in circumstances where acquired shares have risen in value before being provided to employees or where shares are issued directly to the employee by the employer.



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