Employee Share Schemes – PUB00364

Submission of the New Zealand Law Society Te Kāhui Ture o Aotearoa

18 April 2024

1 Introduction

1.1 The New Zealand Law Society Te Kāhui Ture o Aotearoa (**Law Society**) welcomes the opportunity to comment on PUB00364, five interpretation statements and one 'question we've been asked' (**QWBA**) relating to the employee share scheme (**ESS**) tax regime.

1.2 This submission has been prepared with input from the Law Society's Tax Law Committee.

2 What an employee share scheme is, the taxing date and apportionment (PUB00364/A)

2.1 The Law Society generally endorses the conclusions reached in these draft documents. The Law Society welcomes the inclusion of examples, which provide useful additional guidance as to the Commissioner's view of the operation of the ESS rules in practice, including the interaction of those rules with other tax regimes, including FBT and PAYE.

2.2 The introduction of the ESS regime in 2018 appears to have achieved its objectives, particularly in terms of confirming the timing of the taxable benefit to employees under an ESS, and giving employers a deduction equal to the value of that taxable benefit. Despite this, more recently there has been criticism of the tax treatment of the ESS regime and the clarity of the rules. For example, the recent 2023 Upstart Nation report has identified the taxation of Employee Share Option Programmes as one of the main issues for founders of start-up businesses.[1]

2.3 The Law Society considers it important that Inland Revenue provide clear guidance on the share scheme taxing date for start-up businesses. Members of the Law Society's Tax Law Committee are aware of additional situations which require consideration of the share scheme taxing date definition in section CE 7B, and that are not addressed in the draft interpretation statement or the QWBA. It would be helpful if the guidance also addressed the following situations:

(a) **Founder shares:** a founding shareholder of a start-up businesses will often obtain shares on or around incorporation of a new company and at a time when the company is virtually worthless (on a balance sheet basis). For tax purposes, the founding shareholder will typically take the view that those shares are not subject to income tax because market value has been paid for those shares and the share scheme taxing date will be on or around the incorporation of the company. This view was supported in Inland Revenue's 2018 ESS Special Report,[2] and example 2 from that report. A similar example would be helpful in this updated guidance.

(b) **Reverse vesting:** a shareholder of a company that is undertaking a capital raise from new shareholders will often accept restrictions being placed on their existing shares. This can arise where, for example, a new shareholder requires a founding shareholder to put some of their shares at risk, in return for a significant capital contribution. As the founding shareholder will have acquired

1 Upstart Nation 2023, Ministry of Business, Innovation and Employment, pp. 25-26.

2 *Employee Share Schemes: A special report from Policy and Strategy, Inland Revenue* (May 2018), accessed online.

their shares for market value and on commencement of the business, their shares should be not considered subject to the ESS rules. The subsequent restrictions should not bring those shares back into the ESS rules. Again, an example in the interpretation statements that confirmed the tax position would be helpful.

3 Deductions for parties to employee share schemes (PUB00364/B)

3.1 The Law Society generally endorses the conclusions reached in this draft interpretation statement but considers the discussion of the Australian decision in *Clough Ltd v FC of T (No 2)*[3] and the resulting *Example/Tauira 4 – Share sale requiring an option plan to be wound up* should be reconsidered by the Commissioner.

3.2 The Law Society submits that *Clough* may have been wrongly decided and/or may not be followed by a New Zealand Court, or may be distinguished, for the following principal reasons:

(a) The judgment of the Full Federal Court in *Clough* takes a highly formalistic approach that is not characteristic of many modern decisions on deductibility and the capital/revenue boundary.[4] In holding that the occasion for the expenditure lay in the corporate takeover and not in gaining or producing assessable income, the Court appears to place great weight on the fact that the company technically took on the obligation to make the cash cancellation payments to employees under the scheme implementation agreement (SIA), rather than following the process in the acceleration provisions in the relevant option and incentive scheme documentation. In taking this approach, the Court gave insufficient weight to the reality that, in a commercial and economic sense, the payments were a reward for the employees' accrued (i.e. prior) service, exactly equivalent to the benefit they would have received under the acceleration provisions (either in shares or cash). The distinction drawn by the Federal Court and noted at paragraph 80 of the Full Federal Court's judgment is commercially and economically insignificant.

(b) Relatedly, the Full Federal Court and the primary judge in the Federal Court placed significant emphasis on the fact the payments were not made to secure the ongoing, future service of the employees after the takeover, whereas invariably equity or equivalent cash awards triggered by a liquidity event are an award for the accrued, past service of the employees and in this way are a revenue expense relating to the company's past income-earning activities.

(c) It appears the Federal Court in the first instance was factually wrong in concluding that the employees' entitlements would only crystallise through "further association" with Clough after the takeover. This finding seems to have influenced the Full Federal Court's judgment, even though it is plain from other observations of the Full Federal Court that many of the awards had already vested prior to the takeover, and others would be subject to accelerated vesting

[3] 2021 ATC 24,801

[4] cf paragraphs 80 and 81 of the judgment.

as a result of the takeover (paragraph 71 and the offer letter quoted at paragraph 78).

(d) The taxpayer's "commutation" argument, dismissed by the Full Federal Court (paragraphs 94 – 98), would (if required) have considerably more force in a New Zealand context, given that as a result of section DV 27 of the Income Tax Act 2007 (**ITA**), a deduction clearly would be available if a company like Clough Ltd granted similar awards and those awards vested and were exercised in the normal course of business, whether the awards were ultimately made in cash or shares.

(e) The deemed expenditure arising under section DV 27(6) ITA is directly linked to the (assessable) award provided to the employee for their services rendered to the company (or group member). In these circumstances it is difficult to see how that deemed expenditure could ever be of a capital character unless (perhaps) the award itself was made in the course and because of the employee's involvement in a capital project undertaken by the company.[5]

(f) Invariably in a takeover or other corporate acquisition, the (employer) entity with the deemed cost under section DV 27(6) ITA will be a group subsidiary whose own capital structure is unaffected by the takeover or acquisition. That entity may be the indirect subject of a capital transaction but is not party to a capital transaction. Further, and particularly in the case where the employer is the New Zealand subsidiary of a multinational group, the employer frequently has no control over or practical involvement in the takeover or acquisition, and no ability to influence the manner in which the relevant international ESS is closed out. Accordingly, to the extent the courts in *Clough* placed significance on the impact of the takeover on Clough's capital structure, in many cases this will be an irrelevant consideration (particularly so in light of section DV 27(6) ITA).

3.3 While in light of the above the Law Society considers that the treatment of *Clough* and Example/Tauira 4 in is the interpretation statement need to be reconsidered by the Commissioner, the Law Society notes it is in agreement with the Commissioner's position in Examples/Tauira 5 and 6. Indeed, the different outcome in Example/Tauira 4 from that in Examples/Tauira 5 and 6, despite the substantive economic and commercial equivalence of the fact patterns and payments made, tends to emphasise the inappropriately formalistic approach in *Clough*.

3.4 In the New Zealand context, the Law Society considers that the legislation should be interpreted in favour of a conclusion that a section DV 27 deduction will always arise to an employer. The stated aim of the legislation, as noted in the Commentary to the Bill[6] at the time of its introduction, was to "provide a deduction to employers providing employee share benefits which matches the income to employees in timing and quantity". In practice, employers have relied on this deduction being available. Guidance

5 E.g. *Christchurch Press Co Ltd v C of IR* (1993) 15 NZTC 10,206.

6 Taxation (Annual Rates for 2017-2018, Employment and Investment Income, and Remedial Matters) Bill.

that indicates a deduction may not be available could undermine the original purpose of the ESS rules.

3.5 Finally, the Law Society notes the references in Examples/Tauira 5 and 6 to the relevant employees not being involved in the sale process. It is unclear how much significance the draft is placing on this factor in concluding that a deduction would be available on the particular fact patterns. The Law Society submits that the level of involvement of an employee in the sale transaction is an irrelevant consideration where the reward is pre-existing and not actuated by the sale/liquidity event. It may be relevant in circumstances where the award is granted as a specific incentive to, for example, ensure that the sale process is successful. The Commissioner's position in relation to this aspect should be clarified.

4 Trustee of employee share scheme treated as nominee (PUB00364/C)

4.1 The Law Society endorses the conclusions reached in this draft interpretation statement. In particular, we agree with the following conclusions:

(a) The better view of paras (a) and (b) of section CE 6 ITA is that they operate to identify the company that the trustee is treated as nominee for, rather than limiting the operation of the section to the issue of shares or related right.

(b) The consequences of this are (as outlined in paras 8-10):

(i) The activities of the ESS trustee will be treated as activities that a company undertakes itself.

(ii) For tax purposes, a company will be treated as holding, issuing and buying back shares in itself.

(iii) Shares held by the ESS trustee will be treated as the company holding the shares in itself in accordance with the treasury stock rules.

4.2 The Law Society also agrees with the analysis of the implications of this for a company's available subscribed capital, the application of the treasury stock rules, and the treatment of dividends paid on shares held by an ESS trustee.

5 Employee share scheme benefits paid in cash – PAYE and Kiwisaver obligations (PUB00364/D)

5.1 In the Law Society's view, this draft interpretation statement sets out a significant change in interpretation by the Commissioner. This is alluded to on page 4, where it is stated:

> *…the Commissioner acknowledges that advice on Inland Revenue's website may give the impression that the election to withhold PAYE applies to both cash and share-settled ESS benefits (rather than only share-settled benefits).*

5.2 Links are then given to Inland Revenue's website as examples of this. At the first link, it states:

> *Employers can choose to pay tax on the ESS benefit or the employee must pay the tax.*

5.3 And at the second:

> *Your employer may choose to deduct tax from your ESS benefits during the year to meet your tax obligations on this income. If they choose not to deduct tax, you'll be responsible for paying tax on these benefits at the end of the year.*

5.4 In the Law Society's view, the Commissioner's guidance appears quite clear that any form of ESS benefit, whether it be in the form of cash or not, may or may not have PAYE withheld depending on the election made by the employer.

5.5 The Law Society therefore submits the draft interpretation statement should acknowledge this is a change in interpretation, rather than clarifying an "impression" that taxpayers may have had.

5.6 The Law Society agrees with this new interpretation. However, we consider that taxpayers should be given a reasonable period to comply with it. A new prospective application date of not earlier than 1 October 2024 would provide time for the Commissioner to consider submissions on this document, issue it in final form, allow employers time to liaise with affected employees and to amend their payroll systems.

6 PAYE – How an employer funds the tax cost on an employee share scheme benefit (PUB00364/E)

6.1 The Law Society agrees with the conclusions reached in this draft interpretation statement. In particular, we agree with the following conclusions:

(a) If an employer chooses to withhold tax from an ESS benefit they provide in shares, the benefit in shares is an "extra pay." This "extra pay" is a PAYE income payment from which the employer has a withholding tax obligation at the relevant extra pay rate. To the extent applicable, student loan deduction applies to this non-cash benefit but not the ACC earner's levy and KiwiSaver deductions.

(b) If an employer funds the withholding tax so that the net benefit the employee receives is the value of the ESS benefit, this additional cash payment is in itself an "extra pay." This "extra pay" is a PAYE income payment from which the employer has a withholding tax obligation at the relevant extra pay rate. In this scenario, a student loan deduction, ACC earner's levy, and Kiwisaver deduction apply to the additional payment.

(c) To ensure the net benefit the employee receives is the value of the ESS benefit, the employer may opt to gross-up any additional payment it contributes for any resulting tax, student loan deduction, ACC earner's levy, and KiwiSaver deduction.

6.2 The Law Society also commends the examples from paragraph [66] provided in the document. The examples provided cover different funding scenarios and will aid taxpayers in determining how the gross-up amount of the additional payment should be calculated.

7 Fringe benefit tax – employee share loans and associates (PUB00364/F)

7.1 The Law Society generally endorses the policy position reached in the draft QWBA, with respect to extending the application of the FBT share loan exclusion to the circumstance where an associate family trust of an employee enters a loan to acquire shares in an ESS.

7.2 The Law Society agrees with the view that the FBT loan exclusion should apply to a trustee which is an associate of an employee, but considers that the discussion around whether the trustee can "beneficially own" shares as required by s CX 35(1)(c) ITA should be reconsidered by the Commissioner before the draft is finalised. Generally, the Law Society's concern is there may be a gap in statutory and case law supporting the proposition that trustees can "beneficially own" the shares. We make the following observations:

(a) The approach taken in the draft QWBA is to read references to the employee as references to the associate in s CX 35 ITA. Consequently, for the exclusion to apply to an associate, the associate must beneficially own the shares, rights, or options in an ESS throughout the term of the loan. However, as pointed out in paragraph [36] of the draft QWBA, s CX 35 ITA does not specifically apply to situations involving trusts and instead concludes (correctly in the Law Society's view) that the associated trust would have to beneficially own the shares in accordance with s CX 35(1)(c) ITA in order for the FBT exclusion to apply.

(b) The draft QWBA then refers to case law which explores what "beneficial ownership" means. The cases referred to, *Martin v Martin*[7] and *FCT v Linter Textiles Australia Ltd (In Liq)*,[8] both express the view that the term "beneficial ownership" should be interpreted depending on context and must reflect the purposes of the section in which it occurs. This then broadens the ambit of possibilities when a person can "beneficially own" an asset and, for current purposes, the shares in an ESS. However, the specific facts of these two cases are not directly helpful in ascertaining whether a trustee can beneficially own a shares in an ESS.

(c) In *Martin v Martin*, the issue was whether the wife was the "beneficial owner" of a house owned by a company in which she held the majority of the shares. This was in the context of whether such investment was separate property under the Matrimonial Property Act 1976. The case essentially extends the idea of beneficial ownership to a shareholder. In the present case, this will be analogous to saying that the employee is a beneficial owner of the shares in an ESS. However, this does not clarify how a trustee of a trust should be considered to the beneficial owner of shares, when a trustee is typically considered to hold only the legal title to the assets in a trust.

(d) Interestingly, *Martin v Martin* also referred to *Ayerst v C & K Construction Ltd*,[9] a case concerned with the distinction between beneficial and legal ownership where a company has been ordered to be wound up. The case considered that the "*vital ingredient of beneficial ownership was whether the owner could enjoy the*

7 [1988] 1 NZLR 722 (HC), at 731.
8 2005 ATC 4,255 at [50].
9 [1976] AC 167.

fruits of the property himself or dispose of it for his own benefit." With family trusts the separation of legal and beneficial ownership of property is a defining feature. If the interpretation of beneficial ownership in *Ayerst* were to be accepted, then a trustee associated with an employee would arguably not be a beneficial owner because they do not enjoy the fruits of the ESS in their capacity as a trustee (i.e. they are legal but not beneficial owners of the shares).

(e) *FCT v Linter Textiles Australia Ltd (In Liq)* presents a similar concern. The issue here was whether tax losses could be used by a parent company as beneficial ownership of the shares of the subsidiary company. At paragraph 52, it was pointed out that the term beneficial owner is a person for "*whose benefit the trustee of a private trust (i.e., not a charitable purpose trust) is bound to administer the property*." It follows that this approach may further support the view that the beneficial owner cannot be the trustee and instead is either the employee themselves or members of the employee's family.

(f) Finally, the draft QWBA at paragraph [38] also cites *Perpetual Trustees, Estate, and Agency Co of New Zealand, Ltd v Commissioner of Stamp Duties*.[10] In this case, Stringer J held that a church had beneficial ownership in a bequest to the church that was applied for the purposes of its foreign missionary work. This was meant to support the view that a person holding funds on trust for a purpose, or to be applied in a particular manner, as being beneficially entitled to the bequest for succession purposes. This may be true for charitable trusts whereby there are no conventional beneficiaries or beneficial owners and a need to extend the concept of beneficial ownership may be warranted. However, for private trusts (e.g., family trusts), there is a clear distinction between legal and beneficial owners.

7.3 In conclusion, although we endorse the extension of the FBT loan exclusion to a trustee associated with the employee, we recommend the Commissioner revisits his comments on whether trustees can "beneficially own" shares as required by s CX 35(1)(c) ITA. We further recommend that a clarifying change in law be made to expressly ensure this outcome.

8 Further questions

8.1 Should you wish to discuss this submission further or raise any questions, please feel free to contact Aimee Bryant, Manager Law Reform and Advocacy (aimee.bryant@lawsociety.org.nz).

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Vice President

10 [1927] NZLR 714.