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Public Consultation
Inland Revenue
Wellington

By email: Rhonda.Gregory@ird.govt.nz

Re: PUB00364: Employee Share Schemes (some specific interpretive issues)

Thank you for your email of 8 December 2020 advising that scoping work is being undertaken in relation to Inland Revenue's Public Advice and Guidance work programme, *PUB00364 Income tax – Employee share schemes (some specific interpretive issues)*, focusing on specific issues that have arisen from the new regime for taxing employee share schemes that came into force on 29 September 2018.

You have asked for feedback about any interpretive issues or uncertainties encountered in applying the new regime that would benefit from public guidance being issued by the Commissioner. Comments are set out below on issues that have arisen from the new Employee Share Schemes rules that the Law Society's Tax Law Committee consider would benefit from further guidance.

1. Section DV 27 and the timing of the corporate tax deduction

The Tax Law Committee agrees with Inland Revenue that more guidance is required to outline when a deduction arises for an amount in relation to an employee share scheme. While it seems to be generally accepted that the deduction arises in the same year in which the employee is treated as deriving the income, there is a lot of uncertainty and conflicting views (including from Inland Revenue) about the point in time when the deduction actually arises (for example, on signing an SPA, transfer of the shares, some other date). This can be particularly relevant on a change of control (for example, on a transaction where ownership changes part way through the year and which includes the acquisition of employee shares). This will often dictate who will be entitled to the deduction (e.g., the buyer or the seller). Clarity should also be provided in relation to new share issues being obtained on a transaction, and whether it occurs when the employee receives the shares.

2. Tax treatment of options

It would be helpful if there was more guidance on the tax treatment of options. While it is accepted that options are generally taxable on exercise and on the difference between the exercise price and market value, there is limited discussion on this point in Inland Revenue guidance. Also, in practice, there can be situations where this tax treatment is less clear. For example, when options in a private company are exercised, the shares obtained may be subject to the further conditions, such as in a shareholders' agreement. Presumably there is a risk that, if any of those conditions would result in the shares being subject to forfeiture for less than market value, then the option holder may not be taxed when the option is exercised but that tax could be delayed until those further conditions lift. However, if those conditions apply to all shareholders, then it would seem to be within the intention of the rules that those restrictions should not delay the share scheme taxing date (i.e., guidance

suggests that employee shareholders should be taxed when they hold the shares like any other shareholder).

3. Hurdle shares

The treatment of 'hurdle' shares does not neatly align with the rules under the new regime and guidance on this issue would be valuable. 'Hurdle' shares are shares that only participate in value above a threshold level of return, with that return threshold embedded in the share itself or elsewhere (and therefore impacting its value relative to ordinary shares). For example, a 'hurdle share' could be issued which only participates in surplus capital after $100 million is achieved (either through the rights attaching to the share itself, which do not change but limit the shareholder's returns above that threshold or through other preference shares on issue which effectively have a priority return and create the same result). The most common form of hurdle share would be one where the rights do not change but the terms of the shares provide for a different participation in the capital of the company, depending on performance (i.e. hurdle shares typically involve a 'hurdle', rather than being 'reclassifying' shares).

This point has not been well understood in previous guidance (refer example 23 of the 2018 Special Report which, confusingly, assumes that the rights under the relevant shares will "change"). This is a common PE / VC model from offshore. Further, these 'hurdle' shares are likely worth considerably less than an ordinary share because of its risk and limitations but may require real investment from participants. 'Hurdle' shares when purchased at market value and held on risk technically fall outside the scope of the new regime entirely. Guidance on how the Commissioner would apply the new regime to 'hurdle' shares would be useful.

4. New Zealand resident employers of employees receiving shares in an offshore company

We note below that Inland Revenue will be considering how a New Zealand parent company issuing shares to an employee of a non-resident subsidiary is taxed (in respect of income and deductions).

We consider that under the new regime a New Zealand resident employer of New Zealand resident employees, who receive shares in an offshore parent company, should be entitled to an income tax deduction. We understand the intended policy outcome is that the DV 27 deduction is available to the New Zealand employing subsidiary when the shares issued/sold are shares in the offshore parent. It would be helpful for Inland Revenue to issue guidance to confirm this.

5. Tax treatment of cash settled share awards or options

Cash settled share awards or options are relatively common in practice, and it would be helpful to have confirmation that cash settled share awards or options will be taxed in the same manner under the new regime, to avoid potential uncertainty.

It would also be useful to get guidance on whether cash settlement amounts are captured by CE 2 as "extra pays" for PAYE purposes. If they are:

- What is IR's position on how the PAYE should be addressed when, as is common, the offshore parent of the New Zealand employing subsidiary pays the cash settlement amount? This may not be preferable where the parent does not want the payment to be "routed" through the NZ payroll for reasons of employee confidentiality.
- Do they give rise to KiwiSaver contribution obligations? There is a degree of incoherence between the way "extra pays" are dealt with in section 4 of the KiwiSaver Act and section CE 2.

6. Valuation of employee share schemes

The valuation approaches which the Commissioner has deemed acceptable in terms of valuing shares is another area of uncertainty in applying the new regime. CS17/01 provided helpful guidance on this issue but it is out of date and technically applies under the old rules. It would be valuable to have clarity on valuation approaches, particularly in the context of withholding and the extension to nearly all schemes now being taxable.

Valuation guidance should consider the following:

- Further guidance would be helpful in terms of the standard of value to be applied. Valuers will tend to work to the 'fair market value' which is the expected standard and is typically defined as: *The price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller, both acting at arm's length*'.
- For unlisted companies (particularly start-up businesses) it is extremely difficult to value a company. In order to obtain certainty, it becomes necessary to obtain an independent report prepared by a valuation expert. There are a number of options Inland Revenue could consider to facilitate this process and ensure the correct valuation of employee shares. One option would be to establish a panel of expert valuation practitioners. Alternatively, the valuation method could be chosen by the company/employer and then reviewed by an independent expert.
- The Commissioner has previously suggested that valuation reports must be compliant with Advisory Engagement Standard 2: Independent Business Valuation Agreements (AES-2). However, this is a high standard that is perhaps not always necessary. In some circumstances, indicative valuation reports would suffice and would be more cost-effective for companies / employers. Guidance (or perhaps a law change) which allows employers flexibility when a high-quality standard is not necessary, would be helpful.
- A consistent timeframe for relying on independent valuations for unlisted companies (including start-up businesses) would provide greater certainty in the tax treatment of employee share schemes. For example, a valuation report given in the last two years should be acceptable.
- In the absence of a practical commercial approach, reference should be made to those additional standard appropriate valuation methodologies for different types of securities, including:

  For shares in unlisted companies:

  - Discounted Cash Flow (DCF) – Value is represented by expected future cash flows, discounted to present value at a rate that reflects the risks inherent in those cash flows. This approach is particularly suited to situations where a business is in a growth phase or requires significant additional investment to achieve its projected earnings (e.g., a start-up company).
  - Capitalisation of Earnings – This methodology requires an assessment of the maintainable earnings of the business and the selection of an appropriate capitalisation rate, or earnings multiple. It is most appropriate where there is a long history of relatively stable returns and capital expenditure requirements are neither large nor irregular. In practice, it is often difficult to obtain accurate forecasts of future cash flows

and therefore the capitalisation of earnings approach is often used as a surrogate for the DCF methodology.

- Net Assets Approach – This methodology values a company's shares based on the net assets on its balance sheet, rather than the future earnings / cash flows it can generate. The valuation reflects an estimate of the proceeds from an orderly realisation of the assets. It is most commonly applied to businesses that are not going concerns, as the valuation result reflects liquidation values and typically attributes no value to any goodwill associated with ongoing trading. It is also used as a valuation cross-check or a 'floor valuation' for well-performing and solvent businesses.

For share options:

- Black-Scholes Merton
- Binomial Option Pricing
- Monte-Carlo Simulation

Shares in listed companies:

- The current approach of valuing shares in listed companies based on observed market prices seems reasonable. However, if there are unique characteristics attaching to shares, perhaps those restrictions should be able to be reflected in value adjustments. For example, an option pricing model would be more accurate at valuing share options rather than ordinary shares. Submissions should be sought to ensure that all practical commercial approaches, particularly for listed companies who are managing tax for their employees, are accepted.

7. Election to disapply all restrictions on shares

A helpful law change which would provide additional certainty in the area of employee share schemes, would be to allow an election to disapply all restrictions on shares awarded to employees (i.e. ignoring situations where shares will be disposed of for less that market value) and effectively fix the share scheme taxing date to the day of award. The United Kingdom (election under section 431 of ITEPA) and United States (43B election) both allow an election by an employee to disapply all restrictions on shares, so that tax is calculated and paid on the value of the shares on award. The objective of these elections is to remove the risk of unexpected deferred tax charges. International companies often find it somewhat surprising New Zealand does not have an equivalent election.

We hope you find these comments helpful. If you have any questions or wish to discuss further, the Tax Law Committee can be contacted through the Law Society's Law Reform and Advocacy Advisor Emily Sutton (emily.sutton@lawsociety.org.nz).

Yours faithfully,

Arti Chand
Vice President