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Dear Sir

Simplifying the collection of tax on employee share schemes

Thank you for the opportunity to comment on the issues paper.

Summary

We support the option for tax on employee share scheme benefits to be collected at source, but not using the existing PAYE or FBT collection mechanisms. In our view, the use of scheduler withholding payments, with a withholding tax rate of 33%, creates the best result in terms of both collecting the tax at source and other objectives (such as not including the value of employee share benefits for KiwiSaver purposes).

A scheduler approach also allows a withholding tax rate of 0% to be applied to support a non-mandatory approach for employers to deduct tax. We consider the withholding option should be elective as different schemes and employers will have different requirements. (There are a number of situations where the payment of tax by the employer is not easily achieved, discussed in detail in this submission, which supports our view that collecting tax at source should not be mandatory.) We note that mandatory provision of employee share scheme benefit information will nevertheless be required.

A number of consequential legislative changes will also be required such as deeming an employer to have met their tax deduction obligations under an employee share scheme (if required to sell shares to cover the tax costs), confirmation that the regular sale of shares to cover tax liabilities does not result in those shares becoming revenue account property, and the non-application of the holiday pay rules where employee share benefits are concerned.

An amnesty should be considered as part of the transition to the new rules. These should be well publicized to ensure employees have a chance to rectify historic non-compliance.

A significant issue is how payroll systems can operate under the Inland Revenue's current IT constraints. The design of the rules needs to be worked through carefully with Inland Revenue Operations to ensure the required approach can be practically achieved.

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General Comment

Employee share schemes are an important remuneration tool for employers. They provide a means for ensuring employee loyalty and engagement in the business. They are also increasingly seen as a means to ensure that remuneration is appropriate based on performance of the company.

It is important that the tax rules do not prevent employee share schemes being used to meet those commercial objectives. The tax rules therefore need to be flexible.

Comment on the current system

The current system leaves employees, who may not be in the habit of filing tax returns, to calculate the taxable income and manage provisional tax in connection with benefits received under employee share schemes. In our experience even motivated taxpayers find this a challenge. They find the use of money interest impacts of the present system unfair when the receipt and amount of the benefit is not predictable, or in cash.

From an employer perspective, the current system means that, although they will be conscious of the tax consequences of an employee share scheme, the employer is not required to fund the tax. The employer, having confirmed an employee’s entitlement to shares, is able to leave the compliance and other effects to the employee.

Comment on the proposed mechanisms for collection and overall changes

We understand that Inland Revenue’s focus is on compliance – both the collection of tax due on employee share benefits and the disclosure of information relating to employee share benefits.

We recognize that the best way for Inland Revenue to ensure overall compliance is to have both the information provided, and for the tax to be paid, by the employer at the time the benefit is provided.

However, there are a wide variety of employee share schemes. The benefits and challenges of tax collection for one type of scheme may well be different for another type of scheme. Given the variety of employee share schemes, employers that provide them, and Inland Revenue’s current IT constraints, a system which meets these objectives is not straight forward to devise.

We briefly consider two options before detailing our preferred option.

Fringe benefit tax (“FBT”) as a mechanism for collection

We believe FBT should be discounted as the tax collection mechanism.

Many multinationals with operations in New Zealand offer entry into employee share schemes as part of total remuneration. These share schemes commonly have a three year period from grant to vesting. Many employees are mobile and would not remain in New Zealand for the full vesting period, meaning taxable income may arise in multiple jurisdictions.

Tax paid in New Zealand on the employee share benefits may be needed to offset foreign tax on the value of the shares vesting. FBT paid in New Zealand would, in most instances, not be able to be used to satisfy a foreign tax liability on the income. This would result in double taxation.

For this reason alone we consider FBT should not be used as a tax collection mechanism for employee share benefits.

Further, not all employers will be in the FBT regime, which also reduces its appeal.

Pay as you earn ("PAYE") as a mechanism for collection

We believe PAYE should also be discounted as the tax collection mechanism.

The current PAYE system does not allow an employee share benefit to be separately identified and included in the Employer Monthly Schedule ("EMS"). This means that the current PAYE system does not allow, without manual override:

- the benefit to be automatically excluded from the calculation of KiwiSaver contributions (both employer and employee contributions); and
- there is no ability to disclose the share benefit without deducting tax (we assume disclosure would be required if the collection method is not mandatory);

This will create significant additional work for employers. It will also create significant work for Inland Revenue as we assume that validation checks on an EMS would fail. This will generate further work to identify and reconcile the errors.

KPMG's preferred solution: scheduler withholding payments

From a practical perspective, we consider the best mechanism to meet Inland Revenue's objectives is through the current scheduler withholding payment rules. These rules allow the collection of income tax and disclosure of information on schemes where tax is not deducted at source.

We recommend that employee share benefit income be treated as scheduler withholding payments, with:

- A new "SBT" code with a withholding rate of 33% for schemes where tax is deducted when the benefit is granted.
- A new "SBE" code with a withholding tax rate of 0% for schemes where tax is not deducted when the benefit is granted.
- The benefit included as a scheduler payment in the three months after the benefit is derived by an employee. For those employers who will be withholding tax on the share benefit value, the use of brokers or repatriation of cash from offshore to fund the tax, and the general calculation of tax (including access to the most accurate information) will require more time than is available in a normal payroll run. Under our proposal, if a share benefit was derived by an employee on, say, 1 July, the share benefit and the tax withheld would be included as a scheduler line item in the October EMS.

The benefits of this approach include:

- ACC and KiwiSaver will not be triggered by inclusion of share benefits as the employee's income. We would therefore not expect validation errors to be generated by Inland Revenue's PAYE system.
- The benefit would be disclosed for *Working for Families* tax credits, and student loan and child support purposes.
- Disclosure of the taxable share benefit will be made to the Inland Revenue for those schemes where tax is not deducted at source. This allows the regime to be elective, rather than mandatory. (We consider why this should be allowed further below).
- The provision of share benefits is outside an employer's payroll systems. For listed companies, the issue of shares will be managed by the company's share registrar, not the payroll (or finance) team. Employee share benefit information will need to be collated and validated, which is more compliance intensive and more susceptible to error than normal employee remuneration. Allowing an additional three months to include employee share benefits, and for the payment of tax, will allow additional time to confirm the accuracy of the underlying information, and the tax deduction, thereby reducing the need for subsequent corrections.

We acknowledge that this proposal would not bring forward the payment of *Working for Families* credits, or student loan and child support payments. This is consistent with the current system and we consider should be maintained for funding reasons (also considered further below). We note that a 33% tax rate on employee share benefit income, rather than a rate which aligns with the employee's marginal rate, goes some way to addressing this. (Those on a lower tax rate will have a credit which can be used to offset these liabilities.)

There is also a problem with the current online filing of the EMS, which does not allow for two line items to be input for a single employee. This flexibility would be required for the monthly salary and the share benefit income to be reported separately. This problem can be addressed by filing a manual amendment to the EMS. If the current system cannot be amended to accommodate two line items, this should be addressed as part of the "Business Transformation" PAYE changes.

We consider that our preferred approach would meet Inland Revenue's objectives while allowing employers flexibility to choose the regime which best meets the requirements of their individual scheme.

Detailed design issues

In the remainder of our submission we consider a number of detailed design issues.

Mandatory versus non-mandatory disclosure of employee share benefits

One of the main impediments to the Inland Revenue not being able to collect tax on benefits provided under employee share schemes is a lack of information on who has received such a benefit.

We support a regime that requires mandatory disclosure of such information, regardless of whether tax is collected at source or not.

Mandatory versus non-mandatory collection of tax at source

We strongly recommend that the regime be elective for the following reasons:

Illiquid shares

Not all shares that are subject to employee share schemes are listed and therefore readily able to be sold to cover the tax liability. This is particularly relevant for start-up companies where they themselves do not have cash to fund the tax.

An elective regime will allow such companies to continue to offer employee share benefits without further cash flow complications.

Practical implementation issues with existing payroll systems

Even where employers are keen to take on the tax deduction and payment for share benefits received by employees under an employee share scheme, payroll systems are complicated and often involve legacy systems. Different employers will require different changes to their current payroll systems to enable the accurate capture of necessary information, and calculation of the benefit value and tax payable. Allowing the employer tax payment mechanism to be elective, allows employers to elect to withhold tax at source if (and when) their payroll systems allow.

Non-resident employees of non-resident employers and former employees with a trailing employee share scheme

Under the current rules, “trailing” shares are included in the tax return for these individuals. (Trailing shares are those where the entitlement vests following cessation of employment, or after they have left New Zealand.)

Where a non-resident employer no longer has a non-resident employee in New Zealand it is likely that the employer will have deregistered for PAYE/scheduler payment purposes. If the collection of tax on employee share benefits is mandatory, a non-resident employer in such a situation will be in a difficult position to comply.

This is also the position for resident employers who have obligations to provide share benefits to former employees. In that case, the benefit is clearly taxable but the employer has no on-going cash or other relationship with the employee from which to fund the tax.

The current system, modified for disclosure requirements, should remain an option for such employers and their employees.

Consequential amendments

Existing schemes – legislative protection from gross up

The tax liability arising on the provision of a share benefit must be funded by an employer. The simplest way to do so is to sell shares to cover the tax (“sell to cover”). This may not always be possible however.

Where the employer and employee have negotiated the scheme on a pre-tax basis, imposing the tax liability on the employer, who is unable to sell to cover the employee's tax liability, will create an additional cost for the employer and a windfall gain for the employee.

Existing schemes which have not contemplated the "net" receipt of the benefit may not legally allow the employer to reduce the share benefit for the tax liability. This would result in the employer needing to fund the tax through a "gross-up" calculation and effectively increase the value of the benefit provided by 50%.

To prevent this, there should be a legislative override such that tax withheld and paid meets the employer's obligation under an existing employee share scheme. A similar provision was included when the Employer Superannuation Contribution Tax was introduced to ensure the employer was not required to gross up the employer contribution.

Blackout periods – deferral of timing of receipt of benefit

The recipient of shares provided under an employee share scheme may be subject to a "blackout" (i.e. trading restriction) period in which they are not able to dispose of shares until the period has ended. This blackout period, which may be either enforced under insider trading legislation, or result of covenants in employment contracts, requires the holding of shares for a certain minimum period.

In these circumstances, the employer may be unable to sell to cover the funding at the time the share benefit arises.

We have considered whether the blackout rules, which are regulatory in nature, should be overridden to allow sale to fund the tax. There are good regulatory and commercial reasons for a blackout period. We therefore consider that deferring the timing of derivation of income (and therefore the deduction of tax) until the blackout period ceases is the better policy response.

We note this is less of a problem under the current rules as the blackout period can be expected to end before terminal tax is due. (The provisional tax problem is not helped by such constraints however.)

Potential revenue account property (from sell to cover)

If one third of shares received as part of an annual vest is sold each year to meet the tax cost on that year's benefit, the level of sales could be considered to be trading and the shares may constitute revenue account property. To remove this risk, we recommend a specific legislative carve out for the regular sale of shares to cover tax costs for employee share benefit income, from being revenue account property.

Unforeseen consequences: holiday pay

We understand that currently holiday pay calculations do not include employee share benefits. If the value of such benefits is included in the EMS, and the pattern of such benefits is such that they are not considered discretionary, then the value of these benefits would need to be included in the calculation of holiday pay. This would result in the actual cost of the schemes to employers increasing by approximately 6%.

We consider that a clarification to the Holidays Act should be made to confirm the current treatment and practice should continue.

Implementation date

We have had feedback from various employers that a 1 April 2016 implementation date would not be achievable in terms of upgrading their payroll systems. Therefore we would recommend an implementation date of 1 April 2017, if the proposal is to be mandatory. (A 1 April 2016 application date would be suitable under our preferred elective approach.)

Amnesty for past non-compliance

There are likely to be a number of employees who unknowing have not paid tax on historic benefits received under employee share schemes. We recommend that an amnesty be introduced as part of the transition to the new rules. The amnesty provided alongside the changes to the taxation of foreign superannuation schemes could be used as a model.

We recommend an amnesty to allow any historic benefits received from employee share schemes that have not previously been returned, to be included in either the 2016 or 2017 income tax return, without incurring any penalties or use of money interest.

Valuation and timing issues

We understand that the issues paper is focused on the collection of tax and disclosure of income from employee share schemes. However, we consider that there are four issues which arise and which are worth considering as part of this consultation.

The value of the benefit

Particularly with unlisted shares, the share benefit is difficult to value. We note that an employee share benefit is likely to have to be accounted for as a "share based payment" by the employing company. A company must therefore have a reasonable basis for valuing the benefit. (We acknowledge that differences in the timing of the recognition of the benefit may mean that there is not an exact match.)

We submit that consideration should be given to valuing an employee share benefit consistently with the value used for financial reporting purposes. This will make compliance with any collection and disclosure rules simpler.

Deductibility to the employer

There is currently an asymmetry in the tax treatment for employee share benefits: they are non-deductible to the company issuing the shares, but taxable to the employee. This asymmetry needs to be addressed as, economically, an employee share benefit is equivalent to a bonus paid to the employee.

Allowing a deduction to the employer will create a tension between the best position for an employer and the employee, as a higher value creates more deductions for the employer but more taxable income for the employee. Again, the employer's financial statement amount should provide a reasonable basis for valuing the share benefit in both cases.

(We note that at current tax rates, there is a 5% net benefit to the fiscal position of this approach).

Timing of derivation – spread over a year

A significant problem with collecting tax on employee share benefits is that often the benefit and the tax will exceed the regular (e.g. monthly) employment income of the employee. This raises the problem of funding the tax.

We submit that a solution to this problem would be to deem the benefit to be derived in equal monthly instalments over the succeeding 12 months.

Viewing a share benefit as a bonus means that it reflects consideration for 12 months (or more) of employment services. This bonus could be spread back over the preceding 12 months but this would require amendment to previous EMS returns filed. This problem does not arise if the benefit is spread forward. We consider there is merit in spreading the employee share benefit over the succeeding 12 month period. This would allow the tax to also be spread and for it to more likely to be able to be funded from regular salary payments.

Value of benefit for multiple location services

As we have noted above, employee share schemes often have a "trail" or period benefit. They relate to a number of years of employment services. The standard practice is to apportion the share benefit over the years of service. This should be clarified.

Further information

We would be happy to discuss in further detail any of the issues raised in our submission. Please feel free to contact Rebecca Armour (on 09 367 5926) or John Cantin (on 04 816 4518).

Yours sincerely

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