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Employee share scheme tax avoidance alert

Snapshot

Inland Revenue has released a tax avoidance Revenue Alert on employee share schemes. Employee share scheme benefits are taxed when the shares are acquired. The taxable amount is their market value less the amount paid by the employee. One of Inland Revenue's concerns is arrangements which fix an early acquisition date so subsequent increases in the shares' value are not taxable.

The Revenue Alert focusses on employee share purchase arrangements that are legal form acquisitions but not, as a matter of substance. There are two examples: where the acquisition is in substance an option to acquire shares and where the shares are issued as one class and subsequently reclassified. In both cases, this artificially reduces the value of the shares at acquisition. Inland Revenue considers that these arrangements are designed primarily to avoid tax.

The Revenue Alert outlines the extremes. It is less helpful in defining the boundary when schemes have a mix of features. Nevertheless, it is an important indicator of Inland Revenue's continued focus on this area. The Revenue Alert is in advance of a likely review of the tax rules in 2016. There is also a current proposal to collect tax on share benefits from employers.

The Revenue Alert confirms that employee share schemes are a key focus area for Inland Revenue

This is, therefore, a key risk for business that offer such arrangements

Existing arrangements should be tested against the criteria outlined in the Revenue Alert

Contact us

Rebecca Armour
Partner
T: +64 9 367 5926
E: rarmour@kpmg.co.nz

Paul Dunne
Partner
T: +64 9 367 5991
E: pfdunne@kpmg.co.nz

What schemes are at risk?

The policy for taxing employee share benefits is that they are substitutable for salary and wages (and bonuses) and should be taxed in the same way. The difference between the shares' market price and the discounted price to the employee, on the date of acquisition, is the measure of the income.

Acquisition date of the shares

The Commissioner's concern is the fixing of the date at which the acquisition takes place. Specifically, whether the acquisition date is artificially brought forward to reduce the benefit by excluding any subsequent increase in the value of the shares.

The Revenue Alert's tests to determine when and whether the employee has acquired the shares are:

- who controls the shares (e.g. can the employee dispose of the shares);
- who can exercise the rights attaching to the shares (e.g. the right to vote);
- who has the right to receive dividends and do they control these amounts;
- who bears the commercial risk from holding the shares;
- are the benefits of ownership enjoyed more by the employer or employee; and
- as a matter of commercial and economic reality is the arrangement more likely to be an "option"?

Example 1 – "in substance" option

The employee acquires shares in the employer for $2 per share, funded by an employer provided loan. As this is the shares' market value there is prima facie no share benefit income to the employee.

The shares are held in trust for the employee until certain performance criteria are satisfied. Until then, the employee does not have any voting, dividend or other participation rights in the shares. The employee can also reject the transfer of the shares.

The shares fully vest in year 3 and are valued at $4 each at the time of vesting.

Inland Revenue's view is that the employee acquires the shares only at the time of vesting as they do not possess the rights associated with share ownership, and can reject the share transfer, until then. The arrangement, therefore, has features and attributes more like an option.

Inland Revenue is likely to argue that the employee has actually received a $2 per share benefit. (The difference between the $4 market value in year 3 and the $2 per share paid.) This is an avoidance argument so ignores the legal arrangements.

Example 2 – reclassification of shares

The employee pays $1 per share for Class B shares that are non-transferable and have no voting or dividend rights. As this is their market value there is, again, prima facie no share benefit income to the employee.

The Class B shares can be reclassified as ordinary shares if certain performance criteria are met. These are met in year 3. The Class B shares are converted to ordinary shares in the company which have a market value of $9 each.

Inland Revenue's view is that that what is acquired is not the actual Class B shares but a highly contingent right to acquire ordinary shares. It is the legal form that is the acquisition of Class B shares.

Inland Revenue is likely to argue the economic and taxable benefit is $8 per share. ($9 per share on reclassification of Class B shares to ordinary shares less the $1 per share paid.)

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Rebecca Armour
Partner
T: +64 9 367 5926
E: rarmour@kpmg.co.nz

Paul Dunne
Partner
T: +64 9 367 5991
E: pfdunne@kpmg.co.nz

Our view

We welcome the release of the Revenue Alert as it confirms anecdotal evidence that Inland Revenue has concerns regarding certain employee share schemes. This is, therefore, a key risk for business that offer such arrangements. Existing arrangements should be tested against the criteria outlined in the Revenue Alert.

However, the examples are not particularly helpful. The two examples could be said to be extreme. This appears to be by design as it is easier to explain the tax consequences of an extreme scenario.

The examples have all the features that Inland Revenue considers mean there is no acquisition of the shares. What is not clear is how the position changes if an employee share scheme has some but not all the features that the Commissioner considers indicates avoidance. In particular, most schemes will have dividend payments going to repay loans to acquire the shares. It would have been useful for the examples to have covered this. By further contrast, Inland Revenue has approved schemes whose key difference appears to be that employees have income and voting rights during the restrictive period.

While comparisons are difficult – Inland Revenue itself confirms that individual facts and circumstances need to be considered – this provides some insight as to what differences Inland Revenue may focus on.

The Revenue Alert follows a proposal to change the taxing mechanism for employee share benefits in a Tax Bill currently before Parliament (you can read more about that change here). A review of the tax rules for employee share schemes, more generally, is expected in 2016. That review will be critical as the current rules, as illustrated by the need for the Revenue Alert, are not clear and act as a disincentive for use of employee share schemes to reward and encourage employee engagement.

For further information

Rebecca Armour
Partner, Tax
Auckland
Phone: +64 9 367 5926
Email: rarmour@kpmg.co.nz

Paul Dunne
Partner, Tax
Auckland
Phone: +64 9 367 5991
Email: pfdunne@kpmg.co.nz

kpmg.com/nz
twitter.com/KPMGNZ