Tax Tips Alert

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Employee share scheme tax bill introduced

On 6 April 2017, the [Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill] introduced proposed changes to the taxation of employee share schemes (ESS) into the legislative process. If enacted as expected, the new law will fundamentally change the way ESS are taxed. The proposed new rules in the Bill are largely in line with what Inland Revenue has signaled through its public consultation process in 2016, with clear signs, in some areas, that Inland Revenue has listened to market feedback. A disappointing feature of the Bill is, however, an absence of any form of differentiation of the new rules for start-ups.

Taxing point of employee share schemes

As expected, the most significant change is the introduction of the concept of a "share scheme taxing date" that will apply to "employee share schemes", the effect of which is to effectively tax all ESS on the same basis as options. Under an employee share scheme, the "benefit" arising at the share scheme taxing date will be subject to tax in the hands of the employee participants. The benefit amount will be calculated under a prescribed formula but will generally be the value of the shares on the share scheme taxing date less what the employee pays or must pay for them (i.e. largely in line with current law).

The "share scheme taxing date" of an ESS is in summary proposed to be the date after which there is no:

- real risk in relation to a forfeiture of the shares; or
- downside protection in relation to the shares; or
- real risk of a change in the terms of the shares affecting their value.

If shares or rights are cancelled or transferred earlier, the earlier date of cancellation or transfer will be the "share scheme taxing date".

While there will be some exceptions, in broad terms, these changes will defer the taxing point under the majority of ESS to the point when shares or share rights vest and the employee receives shares unconditionally. This will bring gains arising over the vesting period to tax (as has been clearly signaled).

The term "employee share scheme" is relatively broadly defined, but, to be noted, excludes:

- a share purchase agreement (the old DC 12 schemes);
- an arrangement that requires market value consideration to be paid by the employee for the shares on the "share scheme taxing date"; and
- an arrangement that requires the employee to put shares, acquired by them at market value, at risk if the arrangement provides no downside protection.

The ESS rules are relatively complex to follow. However, the Commentary to the Bill provides some guidance to interpretation. The net effect of the above exclusions (supported by examples in the Commentary) appears to be that if an employee purchases shares at market value and is fully exposed to risk in relation to those shares (e.g. via a full recourse loan), that arrangement will not fall within the new rules even if the shares are subject to the risk of forfeiture e.g. if (say) the employee leaves employment within a defined vesting period. Notably, however, this will not apply if the shares are not acquired at market value. This is an important distinction.

Employer deduction

The proposed tax deduction to employers for providing share benefits is largely unchanged from what has been signaled by Inland Revenue through its consultation process, and represents a significant plank in the underlying tax policy of the ESS changes i.e. to align the tax consequences of remuneration in the form of shares with the tax consequences of cash remuneration.

In summary, employers will be entitled to a tax deduction equal to the taxable benefit derived by the employee on the "share scheme taxing date" and employers will be denied a deduction for costs actually incurred in relation to the scheme (e.g. a recharge or cash bonus to fund loan repayment), other than scheme administrative or management costs.

Two important points are to be noted in this context:

- Given that the transitional rules and grand-parenting are based on the date of "grant or acquisition" of the shares (see further below), employers will be entitled to a tax deduction in relation to options or performance rights issued prior to the effective date of the new rules, provided the grant or acquisition of the underlying shares arises after the effective date of the new law. This is an important change to the position signaled in the September 2016 Discussion Document released by Inland Revenue (which suggested this scenario would also be grand-parented and a deduction therefore denied). We know some companies are considering an early transition from a share loan scheme to an option or share right type scheme as a result of this development.
- The availability of a deduction for employers, even in the absence of a tax cost, will provide a potential funding facility by which tax paying employers could fund the cash cost of PAYE on the employee shares, should the employer elect into the new withholding regime. This is likely to make election into the PAYE regime a more attractive proposition for many companies. As outlined below, however, loss making companies will be unable to make use of this mechanism.

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Start-ups disadvantaged

Disappointingly, the Bill contains no concessions for start-up companies. In our view, this is a missed opportunity and, counter intuitively, results in the new ESS rules effectively disadvantaging start-ups relative to larger established corporates. The proposed rules will, in short, potentially result in the effective tax rate under a start-up ESS being 28% more than under an ESS operated by a large tax paying corporate. This is counter intuitive and should be rectified.

Start-ups often adopt ESS because they are cash poor. ESS provide them with a cashless mechanism by which they can compete in a competitive global talent market (often against companies with much deeper pockets). This arguably makes ESS more valuable to start-ups than larger corporates. Imposing tax on ESS in this environment can, however, be punitive given there is frequently no share liquidity when the tax obligation arises.

The new ESS rules not only impose a tax cost on employees in relation to ESS on an unrealised basis (making ESS much less attractive for start-ups) but do so at significantly higher effective tax rates for start-ups than for tax paying "cash rich" established companies.

At marginal tax rates, the effective tax rate of an ESS for large tax paying corporates will effectively be 5%. This arises by virtue of the difference between the tax effect of the corporate tax deduction at 28%, and the employees' marginal tax rates at 33%. We expect some corporates will pass the tax benefit of the tax deduction to employees on a grossed up basis, with the tax cost effectively largely funded by the tax deduction. The effective net tax paid under this scenario would be 5%.

Start-ups on the other hand are typically both cash poor and in a tax loss position and so will be unable to take advantage of this mechanism. This results in an effective practical tax cost of 33% to the employees of start-ups, as compared to the potential effective tax rate of 5% for employees of larger established tax paying employers.

Given the start-up community is the sector which most needs ESS to be able to compete globally, and typically implements ESS precisely because of their cashless nature, this is counter intuitive and a missed opportunity.

We urge the Government to consider rectifying this by allowing the offset of the ESS tax deduction for loss making companies, against the resulting tax liability of employees under ESS.

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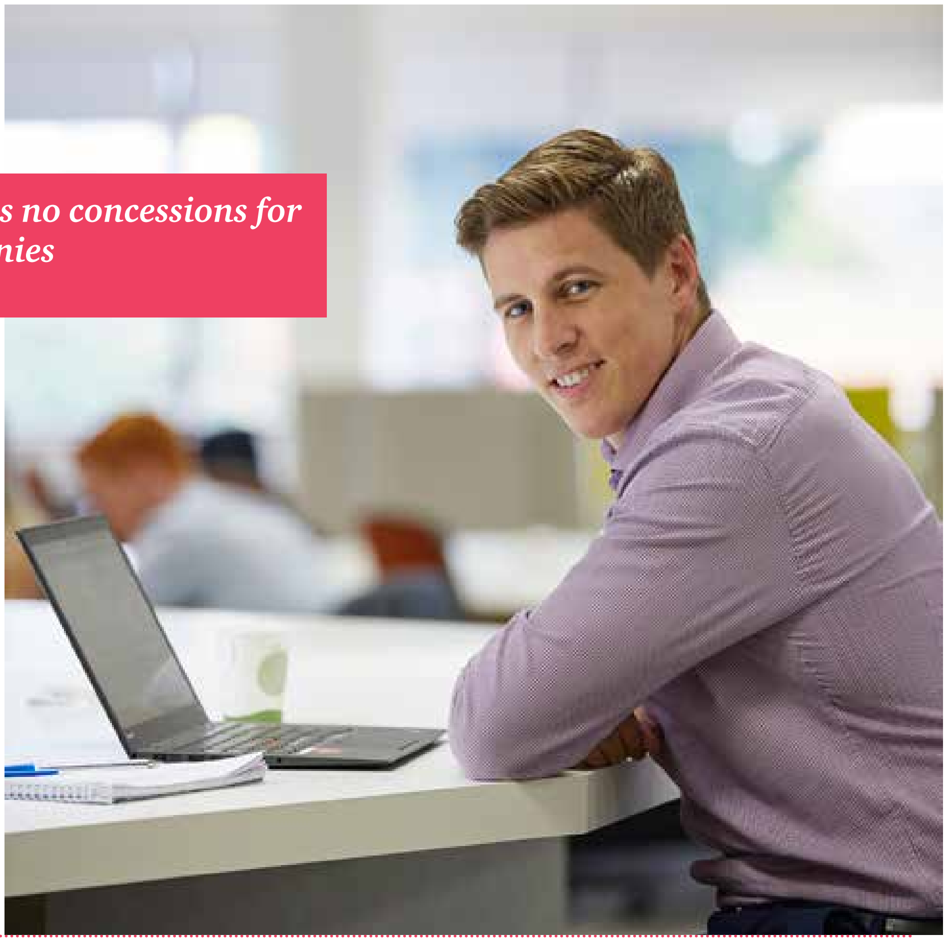

Grand-parenting

Because of the long term nature of most ESS, grand-parenting of existing law for existing schemes is an important element of the proposed new rules.

In our view, the grand-parenting rules in the Bill are clear, concise, and reasonable.

In summary, the key aspects of the new rules (i.e. the shift to a deferred "share scheme taxing date" approach to the taxing of ESS) will largely take effect six months after the new law is enacted (enactment is expected to be late 2017). This provides a reasonable period for employers to consider the appropriate approach for them under the new law, and ensures current law will generally continue to apply to grants made before the new law takes effect for those schemes most impacted by the changes.

The transition provisions of the Bill hinge on two factors – firstly, when shares are "granted or acquired" and, secondly, when the "share scheme taxing date" arises.

The "grant or acquisition date" of shares is the key determinant of grand-parenting. In summary, subject to the cut-off date as outlined below, provided shares are "granted or acquired" before the effective date of the new legislation (six months after enactment), the ESS should be subject to grand-parenting of existing law. The proviso to this is that the "share scheme taxing date" (as defined in the new rules) must arise before the cut-off date of 1 April 2022. Shares granted or acquired under an ESS before 12 May 2016 will, however, be indefinitely grand-parented (i.e. the cut-off date will not apply).

The effect of the above provisions is that the current tax treatment of most loan-based ESS should be preserved for both:

- existing share grants; and
- any new share grants made up to a date six months after the new legislation is enacted.

The proviso to this is that, with the exception of pre May 2016 grants, the share grants must vest and the shares must be transferred to employees unconditionally before 31 March 2022 (as most current schemes will do).

On the other hand, as outlined earlier, for options and share rights issued before the new legislation takes effect, a tax deduction will still be available provided the underlying shares are "granted or acquired" by the employee after the effective date of the new law. This means, for those companies that currently adopt one of these common mechanisms, the new ESS rules are only beneficial.

Adopting the "grant or acquisition date" as the basis upon which grand-parenting operates is sound in principle and will minimise confusion, as the acquisition date of shares is the basis upon which ESS are taxed. These rules will therefore enable an orderly transition from current to new law, and significantly ease the transition process for taxpayers.

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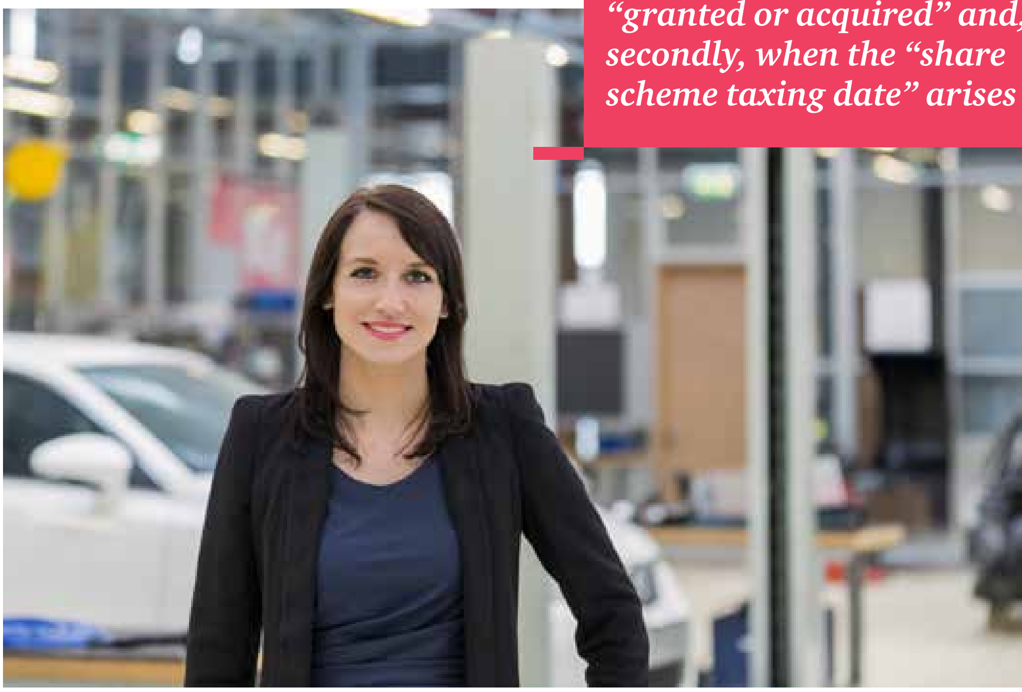

DC 12 tax concessionary schemes

As signaled, the Bill retains the concessionary DC 12 employee share schemes (now to be termed "share purchase schemes") in a modified form, with increased, more generous share thresholds. The new regime should be significantly more attractive and user friendly for employers.

Four important practical features of the revised regime are:

- the definition of "share purchase scheme" includes a scheme which has received Inland Revenue approval under the current regime – so there is no need to abandon or revise schemes that have already been approved under current rules (although companies may choose to do so as the new regime will be more generous);
- the discontinuation of the requirement for Inland Revenue approval, with a shift to schemes requiring registration with Inland Revenue only;
- the absence of grand-parenting, which means the new regime can be adopted upon enactment of the new law (with no six month delay to the new rules becoming effective);
- the removal of the requirement for a share trust.

Proposed modifications to the substantive requirements for DC 12 Schemes include, inter alia, that:

- employers will not be entitled to any tax deduction for the cost of acquiring shares or in relation to the benefit delivered to employees (preserving the "neutrality with cash" principle underpinning the ESS rule overhaul);
- increased thresholds - the cost of shares would need to satisfy three requirements:
  - no more than $5,000 per annum;
  - no more than $2,000 less than market value per annum; and
  - no more than market value.
- any employee cost which is more than nominal must be funded by an interest free employer loan.

Other revised requirements are likewise more attractive than the current regime.

Rollover relief for replacement schemes

An important clarification of an ambiguous area of current law is in relation to the "rollover" from one scheme to another. The formula for calculating the taxable benefit arising under an ESS makes it clear that, in calculating the benefit, shares or rights received under a replacement ESS will be ignored. This means that, for example, swapping one option scheme into another (e.g. on a takeover or acquisition) will not trigger a tax liability. This is an area of confusion and debate under current law and a welcome clarification.

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Penalties

The Bill introduces teeth to the new PAYE withholding and reporting rules applicable to ESS from 1 April 2017.

In summary, if an employer under-reports an ESS benefit arising for an employee under the new reporting regime, the amount under-reported will be deemed a "tax shortfall" of the employer regardless of whether the employer has elected to withhold PAYE or not. This provision will also apply from enactment (i.e. no grand-parenting applies).

However, it is important to note that the reporting regime only applies where there is a benefit that is subject to tax under either current law or the new law. If an ESS is not subject to tax, there is no reporting requirement.

We believe this development will compound the challenges of the new reporting regime and proposed new ESS rules for companies that have no liquid market for their shares. These rules will effectively oblige companies without a ready market for shares to either:

a. obtain a market valuation of shares whenever a "share scheme taxing date" arises under an ESS (imposing a very significant compliance cost on employers);
b. structure their ESS to ensure that the "share scheme taxing date" only arises at a time when a value can be readily derived (e.g. on a liquidity event) – resulting in the tax rules taking preference over commercial objectives; or
c. adopt a cash scheme – resulting in a potentially significant cash cost and balance sheet liability for employers.

For companies without a ready market for shares, the combination of an effective tax on unrealised gains under the proposed new ESS rules, with a reporting and valuation obligation imposed on the employer, will in our view simply make ESS less attractive and less viable for employers to offer to employees – an effective disincentive to the use of ESS.

We urge the Government to consider:

- elective deferral of the taxing point of ESS to a liquidity event in the case of start-ups and other companies with no share liquidity;
- adopting simplified valuation rules for companies below certain size thresholds (in line with Australia).

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Get in touch

If you would like to contribute to the PwC submission, or would like to discuss the implications of the proposals for any current or future share schemes, please feel free to contact Chris Place, Tax and Executive Reward Services.

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