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## WEEKLY COMMENT: FRIDAY 1 MAY 2015

1. Last week I looked at the tax implications of employee share schemes under current rules. This week I look at the proposals for changes in *Simplifying the collection of tax on employee share schemes – An officials’ issues paper* (“the Share Schemes Issues Paper”) released on 1 April. As noted last week, officials wish to address difficulties faced by employers and employees in accounting for tax on benefits. However, another main reason for the proposals is to improve compliance with the law and provide greater certainty that the law is being complied with.
2. Officials are clearly of the view that the present rules, which require the employee to return the income from a benefit received under a share purchase agreement, are untenable. Their preferred solution is to tax such benefits at source using the existing PAYE system, although FBT has been discussed as a possible option.

### Identified problems with the current system

3. From Inland Revenue’s perspective, the key advantages in switching to taxing employee share benefits at source are:
  - (a) The increased likelihood of compliance and tax recovery; and
  - (b) The reduced administrative costs associated with auditing and enforcing compliance.
4. However, a number of disadvantages with the current system that affect employees have been set out:
  - (a) The receipt of a benefit under a share purchase agreement will require an employee to file an IR 3 tax return, which may otherwise not be required;
  - (b) The tax payable will have to be financed:
    - (i) Out of after-tax cash salary; or
    - (ii) By selling some of the shares (if there was a ready market and the employee was not restricted from doing so); or
    - (iii) By way of a loan from the employer or a third party;
  - (c) The employee may become a provisional taxpayer for the year in which the benefit is received;
  - (d) If the employee’s residual income tax is \$50,000 or more as a result of the benefit, use-of-money interest will be charged;

- (e) The employee may become a provisional taxpayer in the following year because residual income tax in the year the benefit is received is \$2,500 or more, and if provisional tax is estimated down, use-of-money interest could apply if residual income tax is \$2,500 or more in the following year;
  - (f) The employee will most probably have to seek expert tax advice because the tax implications are difficult.
5. Officials have suggested that the above problems could provide a tax disincentive to employees participating in an employee share scheme. Providing at least the option for an employer to deal with the employee's tax liability arising from participating in an employee share scheme would benefit the employee in terms of reduced compliance costs, and the employer by removing the tax disincentive for employees to participate.

### **Making benefits from share purchase agreements PAYE income payments**

6. Officials are of the view that the existing PAYE or FBT system should be used, although they have apparently considered and discarded the idea of introducing a new withholding tax. If the PAYE system is used, the benefit under a share purchase agreement would be treated as an "extra pay" in the Employer Monthly Schedule and a corresponding amount of PAYE would be paid. The FBT system is designed to be used for non-monetary remuneration, however, officials prefer the PAYE system for the following reasons:
- (a) All employers operate a PAYE system, whereas some employers may not provide fringe benefits;
  - (b) The tax will be collected in a more timely manner because PAYE returns are filed monthly or twice-monthly, whereas FBT returns are only file quarterly;
  - (c) The economic incidence of the tax remains with the employee, whereas FBT is, prima facie, a cost to the employer, however, officials acknowledge that with new schemes the economic incidence can be contractually determined;
  - (d) Funding the tax presents similar problems to those faced in the case of employer-provided accommodation at present, and contractual arrangements are expected to be sophisticated enough to deal with this problem:
    - (i) The employer could recover the cost from the employee by deducting it from after-tax salary; or
    - (ii) If circumstances permit, the employer could sell some of the shares; or
    - (iii) The employer could agree to provide a cash gross-up.
7. Officials acknowledge that the PAYE system could not be used in some circumstances. Where employees are provided with options, they could be exercised without the employer's knowledge, or sold to non-associates without the employer knowing the sale had occurred or the price. In such circumstances employees would have to continue to account for the tax on the benefit by filing an IR 3 tax return.
8. Officials also acknowledge that in circumstances where the benefit is too large to be funded in a particular pay period, there may be a need to offer an income spreading option.
9. Officials also acknowledge that existing employee share schemes' contractual arrangements may have been negotiated on the basis the employee would account for the tax. Therefore, there may be a need for a "grandparenting" arrangement to allow employers to elect to

continue with the current filing and tax payment arrangements. However, to promote compliance, officials propose that any election by employers to retain the current arrangement would need to be accompanied by an obligation to provide a schedule detailing the names and IRD numbers of participating employees and the value of the employee share scheme benefits provided to each employee.

10. As an alternative to grandparenting, officials have suggested a phase-in of the new rules over several years.

#### **Employer deductions for the provision of employee share scheme benefits**

11. Officials have stated that any legislative amendment would seek to ensure that any deductions available to an employer in relation to employee share scheme benefits would not change.

#### **Tax treatment of employee share scheme benefits that have a cross-border element**

12. Officials have also stated that any legislative amendment would seek to ensure that changing the collection of tax on employee share scheme benefits would not alter the substantive tax treatment where the employee provides services in New Zealand and overseas.

#### **Treatment of employee share scheme income for ACC and social policy purposes**

13. Officials recommend that the changes should not affect the existing status quo regarding the impact of benefits from share purchase agreements on ACC and social policy entitlements or obligations:
- (a) The benefit would be excluded for ACC earner's levy purposes (because ACC entitlements should not be based on a one-off increase in income);
  - (b) The benefit would be included for Working for Families tax credits, as is currently the case;
  - (c) The benefit would be included for student loan purposes (as income for student loan purposes has been broadly aligned with income for Working for Families purposes from 1 April 2014);
  - (d) The benefit would be included for child support purposes, as child support is based on taxable income (although the meaning of "from 1 April 2016" in brackets is unclear);
  - (e) The benefit would be excluded for KiwiSaver purposes because officials note that it would be difficult and impractical for the employer to withhold 3% of the value of the benefit and pay it into a KiwiSaver fund.

#### **Substantive treatment of employee share schemes**

14. Officials have stated that they are aware of wider issues with the taxation of employee share schemes and employee option schemes. These wider issues are being considered and officials intend to commence consultation on these issues later this year.



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