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INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

What an employee share scheme is, the taxing date and apportionment

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This interpretation statement considers what an employee share scheme is, when the share scheme taxing date arises and how benefits are apportioned.

All legislative references are to the Income Tax Act 2007 (Act) unless otherwise stated.

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Introduction | Whakataki

1. The employee share scheme (ESS) tax regime changed in 2018. The objective of the changed rules is to treat ESS benefits neutrally so that, to the extent possible, whether remuneration for labour is paid in cash or shares the tax position does not change for either the employer or the employee.

2. Following the changes to the rules, we have received various questions about how the law applies in certain scenarios. This statement addresses some of those questions by explaining what constitutes an ESS, when the share scheme taxing date (SSTD) arises and how benefits are apportioned. Examples at the end of the interpretation statement show how the rules apply.

3. This interpretation statement does not consider the implications of any anti-avoidance provisions. The outcomes set out may not apply where the general anti-avoidance provision (s BG 1) or the specific ESS anti-avoidance provision (s GB 49B) applies.

What is an employee share scheme?

4. Section CE 7 defines an ESS as follows:

> **CE 7 Meaning of employee share scheme**
>
> **Employee share scheme** means—
>
> (a) an arrangement with a purpose or effect of issuing or transferring shares in a company (**company A**) to a person—
>
> (i) who will be, is, or has been an employee of company A or of another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:
>
> (ii) who will be, is, or has been a shareholder-employee in relation to company A or in relation to another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:
>
> (iii) who is an associate of a person described in subparagraph (i) or (ii) (**person A**), if the arrangement is connected to person A's employment or service; but
>
> (b) does not include an arrangement that—
>
> (i) is an exempt ESS:
>
> (ii) requires market value consideration to be paid by a person described in paragraph (a) for the transfer of shares in the company on the share scheme taxing date:
>
> (iii) requires a person described in paragraph (a) to put shares, acquired by them for market value consideration, at risk, if the arrangement provides no protection

against a fall in the value of the shares and none of the consideration for acquiring the shares is provided to the person under an agreement that it is used for acquiring the shares.

5. Broadly, then, an ESS is an arrangement with a purpose or effect of issuing or transferring shares in a company to an employee if it is in connection with the employee's employment or service. In this context, an employee includes a person who will be, is or has been an employee or shareholder-employee of the company. An ESS includes providing shares to employees of another company in the same group, or to an associate of an employee, if this arrangement is in connection with the employee's employment or service.

6. Given the person who receives shares under an ESS could be the employee or an associate, this interpretation statement refers to such a person as the "ESS beneficiary" (as also defined in s CE 7C). Regardless of who the ESS beneficiary is (ie the person who receives the shares or related rights), it is the employee that derives any employment income from the ESS under s CE 1(1)(d) and s CE 2 (see at [24] and [25]).

7. An "arrangement" is defined in s YA 1 to mean "an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect". It includes all aspects of a scheme, such as direct transfers of shares, loans to buy shares, bonuses, put and call options and transfers to trusts.

8. Three exclusions are set out in s CE 7(b) for schemes that would otherwise be an ESS. These are discussed from [9]. Examples | Tauira 1 to 3 illustrate how some of the exclusions set out in s CE 7(b) may apply.

First exclusion – exempt employee share schemes

9. The first exclusion is set out in s CE 7(b)(i) and is for an "exempt ESS". An exempt ESS is a scheme that meets the criteria set out in s CW 26C. Broadly, the criteria are intended to ensure that the scheme is genuinely offered to the vast majority of employees on equal terms and all employees can afford to participate in the scheme (ie not just the more highly paid employees). There is a limit on the amount of benefit that can be provided.

10. Unlike a benefit from an ESS, a benefit derived from an exempt ESS is not employment income under ss CE 1(1)(d) and CE 2. Rather, it is exempt income of the employee under s CW 26B. For more information, refer to **Employee share schemes** *Tax Information Bulletin* Vol 30, No 5 (June 2018): 71.

Second exclusion – market value paid on the share scheme taxing date

11. The second exclusion is set out in s CE 7(b)(ii). It applies if market value consideration is paid by the ESS beneficiary for the transfer of shares in the company on the SSTD. In such a situation, the employee has not received any net value in respect of their employment that could be considered as received in substitution of salary.

12. Section CE 7CB defines the term "market value" for an ESS:

> **CE 7CB Meaning of market value**
>
> **Market value**, for an employee share scheme—
>
> (a) has the same meaning as in section YA 1 (Definitions), definition of **market value**, paragraphs (a) and (b); and
>
> (b) includes, for a share or option quoted on the official list of a recognised exchange, at the time, an amount equal to the 5-day volume weighted average price or any other method that is accepted by the Commissioner or is comparable to the 5-day volume weighted average price, for such shares or options.

13. Paragraphs (a) and (b) in the definition of "market value" in s YA 1 state:

> **market value**,—
>
> (a) for a share or option quoted on the official list of a recognised exchange, at the time, means an amount equal to the middle market quotation at the time for a share or option having the same terms as the share or option to be valued, unless the quotation is not a fair reflection of the market value, having regard at the time to the matters referred to in paragraph (e) of the definition of **recognised exchange**:
>
> (b) for a share or option not quoted on the official list of a recognised exchange at the time, means the amount that a willing purchaser would pay to acquire the share or option in an arm's length acquisition at the time and that is determined using a method that—
>
> (i) conforms with commercially acceptable practice; and
>
> (ii) may, in appropriate cases, have regard to the present value at the time of the company's anticipated income or cash flows and the realisable value at the time of the company's assets; and
>
> (iii) results in a valuation that is fair and reasonable:

14. The definitions deal with shares that are quoted on a recognised exchange and those that are not. For the former, the market value will usually be the quoted value on the exchange at the relevant time but s CE 7CB(b) extends the range of values that are acceptable. For the latter group of shares, the market value will be the value that a

willing purchaser would pay at arm's length for the shares with certain qualifications as to the method that is used to determine the amount.

15. CS 17/01 **Valuation of employee share schemes** provides guidance on what methods are acceptable to us for determining the value of shares received under an ESS. It deals with listed and unlisted shares. CS 17/01 was published prior to the current rules coming into effect and will be updated and re-issued. In the meantime, the discussion of "value" set out in CS 17/01 remains useful.

16. This second exclusion applies if market value consideration is paid for the transfer of the shares on the SSTD. The SSTD is considered in more detail from [24] and is broadly when shares are held by the ESS beneficiary or for their benefit and there are no conditions or protections under the ESS that defer the date under s CE 7B(1)(a).

Third exclusion – shares at risk and market value consideration provided for their purchase

17. The third exclusion, as set out in s CE 7(b)(iii), may apply when market value consideration is paid other than on the SSTD.

18. The third exclusion applies if:

    - the ESS beneficiary pays market value consideration to acquire the shares;
    - the ESS beneficiary puts the shares at risk and the arrangement provides no protection against a fall in the value of the shares; and
    - none of the consideration for acquiring the shares is provided to the ESS beneficiary under an agreement that it used for acquiring the shares.

19. The ESS beneficiary will put shares at risk with no protection against a fall in value if they may be required to transfer the shares for market value and bear any resulting economic loss.

20. For example, the terms of the arrangement may require the ESS beneficiary to sell the shares back to the employer if the employee resigns within a specified period. If the selling price is for an amount equal to the lower of market value and the cost of the shares, then the ESS beneficiary will be putting the shares at risk and will not be protected against a fall in the value of the shares (meaning the exclusion may apply). This exception applies because if the shares decline in value and the ESS beneficiary is required to sell them back to the employer, the employee will bear that economic loss as they will only receive market value.

21. A contrasting scenario is where the ESS beneficiary is required to sell the shares back to the employer for an amount equal to the cost of the shares if the employee resigns within a specified period. In this case, the ESS beneficiary will be putting the shares at

risk but will also be protected against a fall in value of the shares (meaning the exclusion will not apply). This is because the cost price of the shares will be returned to the ESS beneficiary and they will not bear any economic loss, even if the market value of the shares has declined.

22. For this third exclusion to apply, the ESS beneficiary cannot be provided with any of the consideration for acquiring the shares under an agreement that the ESS beneficiary uses it to acquire the shares. For example, the exclusion will not apply if the employer makes a loan (regardless of whether the terms are commercial or not) or pays a bonus to the employee with a requirement that those funds are used to purchase the shares.

23. We have discussed what constitutes an ESS as defined in s CE 7, and what arrangements the Act expressly excludes from being an ESS. We now turn to discuss when the benefit under the ESS arises and needs to be calculated – that is, when the SSTD occurs.

Share scheme taxing date

24. Section CE 1(1)(d) provides that an amount a person derives in connection with their employment or service is income if it is a benefit received under an ESS. The amount of the benefit is calculated on the SSTD using the formula in s CE 2(1). This section states:

> **CE 2 Benefits under employee share schemes**
>
> *Benefit*
>
> (1) A person who is an employee share scheme beneficiary described in section CE 7(a)(i) or (ii) receives a benefit for the purposes of section CE 1(1)(d) in relation to shares or related rights under the employee share scheme equal to the positive amount calculated on the share scheme taxing date using the formula—
>
> share value − consideration paid + consideration received − previous income.

25. Section CE 2(2) defines the items in the formula. Broadly, the amount of the employee's benefit under s CE 2(1) is the market value of the shares or related rights that an ESS beneficiary owns on the SSTD (or the amount of consideration paid or payable to an ESS beneficiary in relation to a transfer or cancellation of the shares or related rights) less any consideration provided by an ESS beneficiary.

26. Section CE 7B defines the SSTD as follows:

> **CE 7B Meaning of share scheme taxing date**
>
> *Meaning*
>
> (1) **Share scheme taxing date** means, in relation to shares or related rights under and employee share scheme, the earlier of the following dates:
>
> (a) the first date when the shares are held by or for the benefit of an employee share scheme beneficiary (**beneficial ownership**) and after which, under the provisions of the scheme,—
>
> (i) there is no material risk that beneficial ownership may change or that a right or requirement in relation to the transfer or cancellation of the shares may operate; and
>
> (ii) there is no benefit accruing to the employee share scheme beneficiary in relation to a fall in value of the shares; and
>
> (iii) there is no material risk that there will be a change in the terms of the shares affecting the value of the shares:
>
> (b) the date when the shares or related rights of an employee share scheme beneficiary are cancelled or are transferred to a person who is not associated with a beneficiary described in section CE 7(a)(i) or (ii).
>
> *Exclusions*
>
> (2) For the purposes of applying subsection (1), the following requirements and rights are ignored:
>
> (a) a right or requirement in relation to transfer by the employee share scheme beneficiary for market value consideration at the time of the transfer:
>
> (b) a right or requirement that is not contemplated by the employee share scheme's provisions:
>
> (c) a right or requirement that, at the time it came into existence, had no material risk of operating or no material commercial significance:
>
> (d) a right or requirement in relation to the transfer of shares, if the right or requirement is 1 that also applies to shares not under the employee share scheme.

27. The SSTD will arise under s CE 7B(1) on the earlier of the following dates:

- Under s CE 7B(1)(a), the SSTD will be the first date when the shares are held by or for the benefit of an ESS beneficiary (referred to as "beneficial ownership") and after which, under the provisions of the scheme, there is no:
  - material risk that beneficial ownership may change or that a right or requirement in relation to the transfer or cancellation of the shares may operate;

  - benefit accruing to the ESS beneficiary in relation to a fall in value of the shares; and
  - material risk that there will be a change in the terms of the shares affecting the value of the shares.
- Under s CE 7B(1)(b), the SSTD will be the date when the shares or related rights of an ESS beneficiary are cancelled or are transferred to a person who is not associated.

28. The remainder of this interpretation statement considers when the SSTD arises under s CE 7B(1)(a). In general, shares would either be transferred to an ESS beneficiary or to a trustee of the ESS and allocated to the ESS beneficiary so there is the "beneficial ownership" referred to in s CE 7B(1)(a). It then needs to be considered whether any of the provisions in s CE 7B(1)(a)(i) to (iii) apply that would defer the SSTD to a later time.

29. In determining whether any of the factors in s CE 7B(1)(a) apply to defer the SSTD, s CE 7B(2) provides that the following rights and requirements are ignored:

    - a right or requirement in relation to a transfer by the ESS beneficiary for market value consideration at the time of the transfer. As Example 14 in *Tax Information Bulletin* Vol 30, No 5 (June 2018): 59 shows, this provision could apply where an employee is required to sell their shares back to the employer if they leave the company after they have vested;
    - a right or requirement that is not contemplated by the provisions of the ESS;
    - a right or requirement that, at the time it came into existence, had no material risk of operating or no commercial significance. As Example 15 in *Tax Information Bulletin* Vol 30, No 5 (June 2018): 59 shows, this provision could apply where an employee has a right to sell shares back to the company for a nominal amount because such a right is unlikely to be utilised; and
    - a right or requirement in relation to the transfer of shares if it also applies to shares that are not part of the ESS.

Are the shares held by or for the benefit of an ESS beneficiary?

30. It is first necessary to establish "the first date when the shares are held by or for the benefit of an ESS beneficiary". These words are abbreviated to "beneficial ownership" in s CE 7B(1)(a). The use of "or" indicates that it does not matter whether the ESS beneficiary holds the shares or someone else holds those shares for their benefit.

31. In this section, we discuss what this requirement means. Example | Tauira 4 and Example | Tauira 5 illustrate how the s CE 7B(1)(a) requirement that shares are held by or for the benefit of an ESS beneficiary impacts on the SSTD.

When shares are "held" by a person

32. This interpretation statement considers "shares" issued by a company registered under the Companies Act 1993 (CA 1993) where those shares are an "interest in the capital of a company" (consistent with para (a) of the definition of "share" in s YA 1). The definition of "share" includes other items such as certain debentures, stapled debt securities and units in a unit trust. This statement does not deal with any of these additional items.

33. The shares must be held by the ESS beneficiary or for their benefit. The Act does not define the phrase "held by".

Ordinary meaning of "shares … held"

34. The most relevant definition of "hold" as a verb in the *Oxford English Dictionary* is:

> **6.a.** To have or keep as one's own absolutely or temporarily; to own, have as property; to be the owner, possessor, or tenant of; to be in possession or enjoyment of.

35. In this context, "held" seems to be about ownership. This definition suggests that determining who shares are "held" by requires a decision about who is the legal owner of the shares.

36. Under s 89(1) of the CA 1993, a person whose name is entered in the share register is the "holder" and assumes legal title. The entry of the name is when the legal ownership "vests" in the named person:

> **89 Share register as evidence of legal title**
>
> (1) Subject to section 91, the entry of the name of a person in the share register as holder of a share is prima facie evidence that legal title to the share vests in that person.
>
> (2) A company may treat the registered holder of a share as the only person entitled to—
>
> (a) exercise the right to vote attaching to the share; and
>
> (b) receive notices; and
>
> (c) receive a distribution in respect of the share; and
>
> (d) exercise the other rights and powers attaching to the share.

37. Similarly, s 84(1) of the CA 1993 provides that the transfer of shares happens when the transferee's name is entered in the share register:

84 Transfer of shares

(1) Subject to the constitution of the company, shares in a company may be transferred by entry of the name of the transferee on the share register.

38. In terms of issuing shares, s 51 of the CA 1993 provides that shares are issued when the name of the holder is entered in the share register:

51 Time of issue of shares

A share is issued when the name of the holder is entered on the share register.

39. Therefore, the legal title or ownership of shares issued by a company in terms of s 51 of the CA 1993 would be determined by who the registered holder of those shares is. The legal owner of shares would "hold" those shares according to the ordinary meaning of the word.

Courts' view of meaning of "shares … held"

40. The ordinary meaning is consistent with case law on the meaning of "held" or "hold" in relation to shares issued by a company. A leading case in this area is the High Court of Australia's decision in *Dalgety Downs Pastoral Company Pty Ltd v FCT* (1952) 86 CLR 335.

41. The court in *Dalgety* looked at s 80(5) of the Australian legislation that governed the carrying forward of company losses. The section required that shares carrying at least 25% of the voting power in the company be "beneficially held" by the same persons during the relevant period. The issue was whether continuity of shareholding had been maintained when a shareholder transferred his shares as security for a loan. The court concluded the shares were held by the person whose name appeared in the company's share register. The court stated at 341–342:

> We are of opinion that the construction of s 80(5) upon which the deputy commissioner acted is correct. Dixon J so held in *Avon Downs Pty Ltd v FCT* (1949) 78 CLR 353, basing his conclusion upon the view that **in the terminology of company law shares are said to be "held" by the person who is registered as a shareholder** in respect thereof, and that s 80(5), being concerned with voting power, should be treated as using that terminology. We share this view. Indeed **it is not too much to say that the verb "hold" and its variants, when used in relation to shares in companies, normally refers to the legal ownership of the shares according to the register of members.** The Companies Acts of the United Kingdom and of several States of the Commonwealth have uniformly used the word in this sense, and common usage has followed their example. **Before a different meaning is accepted, some justification must be found in the context, or the subject-matter.** No such justification is provided by the fact that

> "held" is modified by the adverb "beneficially". This word serves more naturally the purpose of excluding the case of a holding for the benefit of others than the purpose of so broadening the meaning of the word "held" beyond the particular significance which it normally has in relation to shares as to make it equivalent to "owned" in the most general sense of that word. [Emphasis added]

42. New Zealand cases such as *Case D27* (1980) 4 NZTC60,621, *Case N26 (*1991) 13 NZTC 3,219 at 3,228, and *BHL v CIR* (2011) 25 NZTC 20-088 have cited *Dalgety* and adopted the same interpretation.

43. The above cases make it clear that beneficial or equitable ownership of shares without registration does not make a person a "holder" of a share that has been issued by a company. A person does not "hold" shares that have been issued by a company until their name is entered onto the company's share register as being the holder of those shares. When the name of the person is inserted onto the share register, that person obtains the legal title to the shares. This legal title makes that person the "holder" of the shares. This interpretation is consistent with the ordinary meaning of "hold" and with the CA 1993. It follows that shares issued by a company will be "held" in terms of s CE 7B(1)(a) by the registered holder of those shares. Before reaching this conclusion, however, it is necessary to consider whether the context of s CE 7B requires some other conclusion.

Context of s CE 7B

44. The court in *Dalgety* considered that if some justification could be found in the relevant context, a reference to "shares … held" in an enactment might not refer to the legal ownership of shares (see the quotation from that case at [41]).

45. Section CE 7B sets out when the SSTD arises for a benefit an employee receives under an ESS. As set out at [4] to [8], for an arrangement to be an ESS under s CE 7, it must have a purpose or effect of issuing or transferring shares to an ESS beneficiary. Accordingly, the underlying premise of an ESS is the issue or transfer of shares to an ESS beneficiary. The definition of SSTD in s CE 7B(1)(a) attempts to determine the point at which an ESS beneficiary has both earned the shares under the ESS and holds the shares like any other shareholder. It aims to identify this point by referring to the first date when the following two requirements are met.

46. First, the shares must be "held by or for the benefit" of the ESS beneficiary. This goes towards ownership of the shares. However, the use of the term "held by or for the benefit of" indicates it would be possible to satisfy this requirement if, for example, a trustee of an ESS trust held shares for the benefit of the ESS beneficiary (as discussed at [55] to [59]). This terminology reinforces that "held by" refers simply to legal ownership of the shares as registered holder, because s CE 7B(1)(a) extends the

concept of holding shares to a person legally holding the shares but for the benefit of someone else.

47. Second, after the date the shares are "held" as described, the ESS must not contain provisions that impact whether the ESS beneficiary bears the risks and rewards of ownership in the manner set out in subparas (i) to (iii) of s CE 7B(1)(a). If the ESS contains such provisions (discussed from [60]), this indicates the employee has not earned those shares yet because, for example, the benefit could be unwound without the ESS beneficiary suffering any economic consequences.

48. Therefore, in the context of an ESS and the SSTD, it is appropriate that shares are "held by" a person when the person has legal ownership.

Exception to the rule – s YB 21

49. Section YB 21 is an exception to this rule. It states:

> **YB 21 Transparency of nominees**
>
> *Treatment of nominee*
>
> (1) In this Act, unless the context otherwise requires, if a person holds something or does something as a nominee for another person, the other person holds or does that thing and the nominee is ignored.
>
> *Who is a nominee?*
>
> (2) A person holds or does something as a nominee for another person if the person acts on the other person's behalf. However, a trustee is a nominee only if the trustee is a bare trustee.
>
> …

50. Section YB 21 has general application and operates as an exception to various provisions of the Act. Where s YB 21 applies, the result is that if someone acts as a nominee for another person, that other person is deemed to hold or do something and the nominee is ignored.

51. Accordingly, s YB 21 can deem that a registered holder acts, and so holds their shares as nominee, on behalf of someone else. If so, that other person will be deemed to "hold" the shares in terms of s CE 7B(1)(a). Section YB 21(2) refers to a person (the "nominee") who "acts on the other person's behalf", including where the nominee is a "bare trustee" for the other person.

52. What it means for a person to be nominee for another in respect of shares is considered in detail from [86] in **IS 12/01: Income tax – timing of share transfers for the purposes of the continuity provisions**. It is unlikely s YB 21 will have a significant impact on outcomes in the context of s CE 7B(1)(a) because of the requirement that

"shares are held by or for the benefit of" an ESS beneficiary. In other words, the definition of SSTD already extends to a person legally holding shares for someone else.

Conclusion as to when shares are "held" by a person

53. As a rule, shares issued by a company will be "held" by the registered holder of those shares (see ss 51, 84 and 89(1) of the CA 1993). The registered holder of shares is the person whose name has been entered onto the share register of the company as the holder of those shares. This is consistent with the plain and ordinary meaning of "shares … held", the approach that the courts have adopted in relation to holding shares in a company (see *Dalgety*, *Case D27*, *Case N26* and *BHL v CIR*) and the relevant context of the Act.

54. In summary, shares will be "held by" a person for the purposes of s CE 7B(1)(a) when the person has legal ownership and is entered on the share register. This conclusion is subject to nominee arrangements under s YB 21 where the principal is deemed to hold those shares and the registered holder will be deemed not to hold those shares. This means that the shares must exist to be held by a person for the introductory wording of s CE 7B(1)(a) to be met. Refer to IS 12/01 for further discussion of what "held by" means in the context of shares in a company and what a "nominee" is for the purposes of s YB 21.

When shares are held "for the benefit of" an ESS beneficiary

55. When shares are "held by" a person is discussed at [32] to [54]. The next requirement is that the shares are held either by the ESS beneficiary, or for the benefit of an ESS beneficiary. The Act does not define the term "benefit". Likewise, it does not define the phrase "for the benefit of an ESS beneficiary". However, the ESS rules help in identifying what this phrase means.

56. Section CE 2 contains rules to determine the value and timing of benefits under an ESS and therefore sets out what the benefit is for the purposes of the ESS rules and when it arises (as discussed at [24] to [27]). Effectively, the benefit is the shares or rights the ESS beneficiary owns on the SSTD, or the consideration they receive for the cancellation of those shares or related rights, less the consideration the ESS beneficiary pays for those shares or rights.

57. As described at [4] to [8], for an arrangement to be an ESS under s CE 7(1) it must have as a purpose or effect that shares will be issued or transferred to an ESS beneficiary. Accordingly, the underlying premise of an ESS is the ultimate transfer of ownership of shares to an ESS beneficiary so that they become the legal owner.

58. Similarly, the premise of the definition of SSTD in s CE 7B(1)(a) is that shares are held (ie legally owned) either by the ESS beneficiary or for the benefit of the ESS beneficiary,

and that the ESS contains no provisions that would defer the SSTD under subparas (i) to (iii). These deferral provisions are discussed in more detail from [60]. For present purposes, these deferral provisions indicate that potential contingencies for a shareholding do not impact on whether a share is "held by or for the benefit of" an ESS beneficiary. This is because s CE 7B(1)(a) envisages contingencies may be present while shares are held by or for the benefit of an ESS beneficiary, providing that those contingencies defer the SSTD under s CE 7B(1)(a).

59. Accordingly, in the context of shares being held for the benefit of an ESS beneficiary as referred to in s CE 7B(1)(a), a person must hold shares (ie be on the share register as shareholder) for an ESS beneficiary for the purposes of the ultimate transfer of legal ownership of the shares to that ESS beneficiary (even though this potentially may be contingent on meeting certain criteria).

Do any of the deferral provisions apply?

60. If an ESS beneficiary holds the shares or has "beneficial ownership" for the purposes of s CE 7B(1)(a) (as described from [30] to [59]), it is necessary to consider whether any provisions that may defer the SSTD set out in s CE 7B(1)(a) apply. This section discusses these deferral provisions. Examples | Tauira 1 to 3 illustrate how some of the deferral provisions set out in s CE 7B(1)(a) may apply.

Material risk of change in beneficial ownership or a transfer of shares

61. The first provision that could defer the SSTD is set out in s CE 7B(1)(a)(i). It applies where there is a material risk that beneficial ownership may change or a right or requirement in relation to the transfer or cancellation of the shares may operate.

62. The Act contains no definition of "material risk". However, two examples are set out in s CE 7B to illustrate what is a material risk that beneficial ownership may change:

Example 1 – Simple vesting period

Acme Limited transfers shares worth $10,000 to a trustee on trust for an employee, Alice, of Acme Limited. Under the terms of the trust, Alice forfeits, for no consideration, any contingent interest or beneficial ownership in the shares if she leaves the employ of Acme Limited within 3 years of the transfer of the shares to the trustee. Alice stays for 3 years, and, under the terms of the trust, the shares are transferred absolutely to her on her 3rd anniversary of employment. It is a material risk, for the 3 years after the transfer to the trustee, that the terms of the trust will operate to forfeit any contingent interest or beneficial ownership in the shares. Consequently, the share scheme taxing date for Alice's shares is her 3rd anniversary of employment.

Example 2 – Vesting subject to misconduct

Acme Limited transfers shares worth $10,000 to a trustee on trust for an employee, Bob, of Acme Limited. Under the terms of the trust, Bob forfeits, for no consideration, any contingent interest or beneficial ownership in the shares if he leaves the employ of Acme Limited because he is dismissed for serious misconduct within 3 years of the transfer of the shares to the trustee. It is not a material risk that the terms of the trust will operate to forfeit any contingent interest or beneficial ownership in the shares. The risk that Bob will be dismissed for serious misconduct within 3 years is not material. Consequently, the share scheme taxing date for Bob's shares is the date when the shares are transferred to the trustee.

63. The first example illustrates that a material risk of a change in beneficial ownership exists if an employee forfeits their benefit by simply choosing to leave employment for any reason. In contrast, the second example shows that a material risk of a change in beneficial ownership does not exist if an employee would only forfeit their benefit in the limited circumstance of being dismissed for serious misconduct.

64. Section CE 7B(1)(a) will only defer the SSTD where there is a material risk. If there is no material risk, the SSTD will arise when the shares are held by or for the benefit of the ESS beneficiary.

Benefit accruing to employee share scheme beneficiary in relation to a fall in share value

65. The second provision that could defer the SSTD is set out in s CE 7B(1)(a)(ii). It applies where a benefit accrues to the ESS beneficiary in relation to a fall in value of the shares.

66. One situation where this provision might apply is if the ESS beneficiary is able to sell the shares back to the employer for the acquisition price to the ESS beneficiary. Another such situation is where the ESS beneficiary acquires the shares with a loan that is limited in recourse to the value of the shares. In either case, the ESS beneficiary does not suffer the economic loss in circumstances where the shares decline in value. Where such terms are present in the ESS, s CE 7B(1)(b) will defer the SSTD until the ESS beneficiary is no longer protected from a fall in the value of the shares – for example, when the loan is either repaid or ceases to be limited recourse.

Material risk of a change in the share terms

67. The third provision that could defer the SSTD is set out in s CE 7B(1)(a)(iii). It applies where a material risk exists there will be a change in the terms of the shares affecting their value.

68. For example, this provision might apply if the ESS provides for restricted shares to be reclassified as ordinary shares and have the same rights as ordinary shares when a

specified event occurs. Where this material risk exists, s CE 7B(1)(c) will defer the SSTD until the specified event occurs.

Apportionment

69. As set out at [24] and [25], the amount of an employee's benefit is calculated under s CE 2(1). It is essentially the market value of the shares or related rights owned by an ESS beneficiary on the SSTD (or the amount of consideration paid to an ESS beneficiary for a transfer or cancellation of those shares or rights) less any consideration provided by an ESS beneficiary.

70. Where an employee is non-resident and derives foreign-sourced income during the period they earn a benefit, s CE 2(5) and (6) contains an income apportionment formula. Broadly, s CE 2(5) allocates a portion of the benefit as non-residents' foreign-sourced income (which is not taxable to the employee). For example, this apportionment might apply where an employee of a New Zealand company moves to Australia part way through earning the benefit, and continues to work for the New Zealand company but performs their employment duties from Australia such that their services give rise to a foreign-sourced amount of income.

71. Section CE 2(5) states:

> **Apportionment**
>
> (5) For the person's benefit under subsection (1), the portion of that benefit calculated using the formula is treated as non-residents' foreign-sourced income—
>
> benefit before reduction × offshore period ÷ earning period.

72. The items in the formula are defined in s CE 2(6):

> **Definition of items in formula**
>
> (6) In the formula in subsection (5),—
>
> (a) **benefit before reduction** is the amount of the benefit under subsection (1):
>
> (b) **offshore period** is the number of days in the item **earning period** on which—
>
> (i) the person is not resident in New Zealand; and
>
> (ii) any services the person performs for the relevant employer give rise to an amount of income that is a foreign-sourced amount:
>
> (c) **earning period** is the period ending with the vesting of shares or relevant rights in the employee share scheme beneficiary and starting with the earlier of—

(i) the first date used to measure the person's right in relation to the vesting of shares or relevant rights:

(ii) the first date that the person has a right in relation to the vesting of shares or relevant rights.

73. The amount that can be treated as non-residents' foreign-sourced income is determined by first establishing the entire period over which the benefit accrues (the "earning period"), and then determining the proportion of that period during which the person is non-resident and not deriving New Zealand source income from their employment (the "offshore period"). The earning period ends when the shares or rights vest.

74. The earning period is intended to reflect the period over which the employee is earning the shares or related rights. This is not necessarily the same as the SSTD when the employee takes ownership of the shares or exercises those rights, which may occur at a later stage. The purpose of apportioning the benefit over the earning period, rather than to the SSTD, is to ensure the employment income resulting from the ESS benefit is taxable in New Zealand to the extent it was earned while the employee was a New Zealand resident and/or deriving employment income sourced in New Zealand. Example | Tauira 6 illustrates how the apportionment may operate when an employee moves to New Zealand during the earning period.

75. The Act does not define what it means for the shares or relevant rights to "vest". The term "vest" is more commonly used in a trust law context. However, in the definition of "earning period" in s CE 2(6), the term "vest" is used to measure the period over which the employee is earning the ESS benefit. In other words, rather than necessarily being used in the context of a trust relationship, it is used to determine when the employee has done what is necessary to have earned those shares or related rights. Accordingly, the Commissioner considers the term "vests" in this context means the employee has done what is necessary to have a present fixed right of future enjoyment of the shares or related rights.

76. In the context of an ESS, a common requirement is that an employee must work for the company for a specified period. Until the employee has worked for that period, they will not have a fixed right of future enjoyment of those shares or related rights as those shares or rights may not come to fruition. The provisions of the ESS may allow employees to retain their benefit if they leave earlier in certain circumstances, such as due to retirement, serious illness or death. Such leavers are often referred to as "good leavers" in the ESS documentation, and the scope of what is a "good leaver" is determined by the ESS documentation. Where an employee retains their benefit under the terms of an ESS if they leave as a good leaver, the Commissioner considers that the employee will have a present fixed right of future enjoyment of the shares or related

rights when they become a good leaver, as they have done what is necessary to earn the shares or related rights that will come to fruition. Accordingly, in such circumstances, the shares or related rights will have vested for the purposes of determining the end of the earning period in s CE 2(5) and (6).

77. As noted at [73], the end of the earning period under s CE 2(6) may not always coincide with the SSTD under s CE 7B. For example, where an employee receives an option to acquire shares that is exercisable following a specified period of employment, the earning period will end at the conclusion of the specified period of employment. This occurs when the ESS beneficiary has done what is necessary to earn the right to acquire shares, ie the option is exercisable. However, the SSTD will not arise until the option is exercised and the shares are held by or for the benefit of the ESS beneficiary, or the option is cancelled or transferred to a non-associate if that occurs earlier. Example | Tauira 7 and Example | Tauira 8 illustrate when the earning period under s CE 2(6) could end and when the SSTD under s CE 7B could arise in those circumstances.

Examples | Tauira

Example | Tauira 1: Shares acquired with limited recourse loan

Employer Co provides an employee with an interest-free loan of $10,000 to acquire shares in Employer Co for market value. The loan is limited recourse in that the amount repayable is limited to the value of the shares at the time of repayment.

If the employee leaves Employer Co before they have repaid the loan, they must either repay the loan or return the shares in repayment of the loan.

Is the arrangement an ESS under s CE 7?

The arrangement has a purpose or effect of transferring shares in Employer Co to its employee in connection with their employment and is therefore an ESS under s CE 7(a).

None of the exclusions to the definition of ESS in s CE 7(b) applies.

Section CE 7(b)(ii) does not apply. While the employee pays market value consideration, they do not do so on the SSTD. The SSTD arises when the loan is repaid (as set out under the next heading of this example).

Section CE 7(b)(iii) does not apply for two reasons. First, the arrangement provides protection for a fall in the value of shares while the limited recourse loan is outstanding. If the shares fall in value below what the employee paid for them, the employee does not bear the economic burden of that fall in value because the

repayment obligation is limited to the value of the shares. Second, Employer Co provided the employee the consideration for acquiring the shares through a loan.

When does the SSTD arise under s CE 7B?

The SSTD will not arise at the time the employee acquires the shares. This is because while the employee holds the shares, the limited recourse loan means that a benefit is accruing to the employee in relation to a fall in the value of the shares. If the shares fall in value below what the employee paid for them, the employee does not bear the economic burden of that fall in value as the loan repayment obligation is limited to the value of the shares. As a result, the SSTD will be deferred under s CE 7B(1)(a)(ii) until the limited recourse loan is repaid.

Example | Tauira 2: Shares acquired with full recourse loan and potential transfer at market value

Employer Co provides an employee with a full recourse loan of $10,000 to acquire shares in Employer Co for market value. If the employee leaves Employer Co and is a "bad leaver", they must transfer the shares to Employer Co for the lower of cost and market value. If the employee leaves Employer Co and is a "good leaver", they must transfer the shares to Employer Co for market value.

A "good leaver" has a very broad meaning under the terms of the scheme: they are anyone who is not a "bad leaver". A "bad leaver" has a very narrow meaning under the terms of the scheme: they are a person who is dismissed for serious misconduct.

Is the arrangement an ESS under s CE 7?

The arrangement has a purpose or effect of transferring shares in Employer Co to its employee in connection with their employment and is therefore an ESS under s CE 7(a).

However, an exclusion to the definition of ESS in s CE 7(b) will apply.

Section CE 7(b)(ii) will be satisfied as the employee pays market value consideration for the transfer of the shares on the SSTD, as the SSTD arises when the employee acquires the shares (as set out under the next heading of this example). This means the scheme is not an ESS and the ESS rules do not apply to the scheme. Accordingly, the employee will not have employment income from an ESS under ss CE 1(1)(d) and CE 2.

For completeness, s CE 7(b)(iii) would not apply to exclude the scheme from being an ESS because Employer Co provided the employee with the consideration for acquiring the shares through a loan.

When does the SSTD arise under s CE 7B?

The SSTD will arise at the time the employee acquires the shares under s CE 7B(1)(a).

While a requirement in relation to the transfer of the shares may operate in that the employee must transfer the shares to Employer Co when they leave Employer Co, this will not defer the SSTD under s CE 7B(1)(a)(i) for the following reasons.

First, there is no material risk that the employee will be a “bad leaver”. As set out in example 2 in s CE 7B, the risk that the employee will be dismissed for serious misconduct is not material. Accordingly, the requirement to transfer the shares for the lower of cost or market value if the employee is dismissed for serious misconduct does not satisfy the criteria of s CE 7B(1)(a)(i).

Second, while a “good leaver” has a very broad meaning in the scheme and therefore the requirement to transfer the shares on being a good leaver is a material risk for the purposes of s CE 7B(1)(a)(i), this requirement can be ignored under s CE 7(b)(2)(a). This is because the requirement is for a transfer by the employee for market value consideration at the time of the transfer.

In addition, the deferral provision in s CE 7B(1)(a)(ii) will not apply. This is because no benefit accrues to the employee in relation to a fall in value of the shares. As the loan is full recourse, repayment is not limited to the value of the shares if they decline in value. Further, if the shares are required to be transferred under the scheme, this is for market value (or cost if lower for a bad leaver), meaning that if the value of the shares declines, the employee will bear the cost of that decline in value. They are required to pay the full acquisition cost price under the full recourse loan, but will only receive market value if a sale occurs under the terms of the scheme.

Example | Tauira 3: Shares acquired with full recourse loan and potential transfer at lower of cost and market value

Employer Co is a New Zealand resident. It exports to Australia and has an employee in Auckland.

On 10 April 2021, Employer Co provides a full recourse loan to the employee so they can acquire $10,000 worth of shares in Employer Co (which is the current market value established by an independent valuation). If the employee leaves Employer Co for any reason during the following 3 years, Employer Co will repurchase the shares at the lower of cost ($10,000) or market value and the employee must repay the outstanding loan.

After 3 years, Employer Co has the right to buy the shares back for full market value if the employee leaves the company. Employer Co does not want the employee to hold its shares if they are not part of the company, but after 3 years Employer Co is prepared for the employee to receive the upside in the shares.

Before then, the employee bears the risk of loss but has no chance of gain. If the shares fall to $5,000 and the employee leaves Employer Co within 3 years, Employer Co will buy the shares back for $5,000 and the employee will lose $5,000 of their $10,000 investment. If the employee leaves Employer Co within 3 years and the shares are worth $20,000, then Employer Co will buy them back for $10,000 and the employee will be denied the upside.

Is the arrangement an ESS under s CE 7?

The arrangement has a purpose or effect of transferring shares in Employer Co to an employee in connection with their employment and is therefore an ESS under s CE 7(a).

None of the exclusions to the definition of ESS in s CE 7(b) applies.

Section CE 7(b)(ii) does not apply. While the employee pays market value consideration on 10 April 2021, that date is not the SSTD. The SSTD does not arise until 10 April 2024 (as set out under the next heading of this example).

Further, s CE 7(b)(iii) does not apply as Employer Co provides the employee with the consideration for acquiring the shares through a loan.

When does the SSTD arise under s CE 7B?

The SSTD will not arise at the time the employee acquires the shares. This is because, while the employee holds the shares, a material risk exists that they will be required to transfer the shares to Employer Co if they leave this employment for any reason. This means the SSTD is deferred under s CE 7B(1)(a)(i).

This requirement is not ignored under s CE 7B(2)(a) for the first 3 years because, if the employee leaves employment during that period (ie before 10 April 2024), the transfer will be for the lower of cost and market value. This means that the transfer will not necessarily be for market value.

However, while Employer Co has the right to buy the shares back from the employee if they leave Employer Co after 3 years (ie from 10 April 2024), this repurchase is for market value. This means that, while there is a material risk that a right in relation to the transfer of the shares may operate from 10 April 2024, as this right is for a transfer by the employee for market value at the time, it can be ignored under s CE 7B(2)(a) for the purposes of applying the deferral provision in s CE 7B(1)(a).

Accordingly, the first date on which the employee holds the shares and none of the deferral provisions applies is 10 April 2024. The employee can enjoy any gain in the value of shares from this date given that they have now met the scheme's criteria. Before this date, the employee has exposure to any fall in value of the shares but cannot receive any upside.

Example | Tauira 4: Delay in issue of new shares following exercise of option

Employer Co grants an option to an employee on 1 June 2021 to purchase 1,000 shares for $500. If still employed after 1 year, the employee can exercise the option at any time starting on 1 June 2022 and ending on 30 May 2023.

The employee exercises the option on 1 September 2022 and pays Employer Co $500. Employer Co issues 1,000 shares to the employee on 15 September 2022.

When does the SSTD arise under s CE 7B?

The employee's right to exercise the option vests on 1 June 2022 when the employee has completed a year of employment and therefore has the right to exercise the option.

The employee exercises the option on 1 September 2022 to acquire the shares. However, the SSTD does not arise at this point as the shares are not in existence and therefore are not held by the employee or by a person for the benefit of the employee. Accordingly, the employee does not meet the introductory wording of s CE 7B(1)(a).

When the new shares are issued to the employee on 15 September 2022 and the employee's name is entered into the share register for those shares, the SSTD will arise under s CE 7B(1)(a).

Example | Tauira 5: Delay in issue or delivery of shares due to insider trading laws

Under an ESS, an employee of Employer Co is entitled to 1,000 shares if they remain with Employer Co for 3 years. The employee satisfies this requirement on 10 August 2022. However, on 10 August 2022 the employee cannot take the shares due to insider trading laws. Instead, the employee takes the shares on 1 September 2022 once the insider information the employee knew has been made public.

When does the SSTD arise under s CE 7B if Employer Co issues new shares?

If Employer Co is to issue the 1,000 new shares to the employee under the terms of the ESS, and it does not do this until 1 September 2022 due to insider trading laws, the SSTD will arise on 1 September 2022 under s CE 7B(1)(a). This is because that is the first date when the shares are held by or for the benefit of the employee. Before 1 September 2022, the shares did not exist and therefore could not be held by any person.

When does the SSTD arise under s CE 7B if shares are held in an ESS trust?

If instead a trustee administers the ESS and holds a pool of shares for transfer to employees, the outcome will be different. Assuming the trustee allocates 1,000 shares on 10 August 2022 to the employee so that the shares can be transferred when insider trading laws allow, the shares will be held for the benefit of the employee at that time. When the employee satisfies 3 years of employment on 10 August 2022, there is nothing to defer the SSTD under s CE 7B(1)(a). Accordingly, the SSTD will arise on 10 August 2022, even though the shares are not transferred to the employee until 1 September 2022.

Example | Tauira 6: Employee moves to New Zealand during earning period

Employer Co, a New Zealand resident company, has an employee who is not a tax resident in New Zealand and performs their employment duties in Germany such that their services give rise to a foreign-sourced amount of income. The employee purchases 1,000 shares in Employer Co under an ESS by paying an acquisition price of $20,000, which is equal to 50% of their market value at the time.

Under the terms of the ESS, a trustee holds the shares for a period of 3 years. At the end of the 3 years, if the employee is still with Employer Co, they will be transferred the shares. If the employee leaves Employer Co before the end of the 3 years, the shares are transferred back to Employer Co for an amount equal to their cost.

The employee works for 2 years in Germany and then moves to New Zealand to work for Employer Co. They become a transitional resident. After 1 year in New Zealand, the trustee transfers the shares to the employee. The market value of the shares is $80,000 at the time of transfer.

When is the SSTD under s CE 7B(1)(a)?

The SSTD under s CE 7B(1)(a) is when the employee receives the shares. This is when the shares are held by the employee and, after this point, none of the matters set out

in subparas (i) to (iii) could apply to defer the date. Prior to this time, there is a material risk the shares will be transferred back to Employer Co if the employee leaves Employer Co. This means the SSTD will not arise under s CE 7B(1)(a)(i) until the 3 years of employment is satisfied.

The amount of the employee's benefit income calculated under s CE 2(1) is therefore $60,000 (being the market value on the SSTD of $80,000 less the cost to the employee of $20,000).

How is the employee's benefit apportioned under s CE 2(5)?

The amount of the benefit that is non-residents' foreign-sourced income for the employee under s CE 2(5) is $40,000.

For the purposes of the calculation, the "earning period" under s CE 2(6)(c) is 3 years. The "offshore period" under s CE 2(6)(b) is the 2 years the employee is not resident in New Zealand and is performing services in Germany such that their services give rise to a foreign-sourced amount of income. Once the person moves to New Zealand and performs services in New Zealand, the offshore period will end.

This means 2/3rds of the benefit amount is treated as non-residents' foreign-sourced income and is not assessable to the employee in New Zealand.

Example | Tauira 7: Good leaver retaining benefit and being issued new shares in accordance with ordinary vesting schedule

Employer Co, a New Zealand resident company, has an employee who is not a tax resident in New Zealand and performs their employment duties in Germany such that their services give rise to a foreign-sourced amount of income. The employee is granted restricted stock units that provide them a contractual right to receive shares under the scheme after 3 years of employment. If they are a "bad leaver" (defined in the ESS as being where they leave the company before the end of the 3 years other than as a good leaver), they forfeit any rights under the scheme. If they are a "good leaver" (defined in the ESS as being where they leave due to retirement, disability or death), they retain their units and will receive the shares at the end of the 3-year period.

The employee works for 2 years in Germany and then retires to New Zealand. They keep their entitlement and are issued new shares at the end of 3 years.

When is the SSTD under s CE 7B(1)(a)?

The SSTD under s CE 7B(1)(a) is when the new shares are issued to the employee at the end of 3 years. That is when the employee holds the shares and when, under the provisions of the scheme, none of the matters set out in subparas (i) to (iii) could apply to defer the date. In other words, this is when the market value of the shares must be determined for the purposes of calculating the employee's benefit income under s CE 2(1).

If the shares were already in existence and held for the benefit of the employee when they retire as a good leaver, the SSTD could arise earlier (as illustrated in Example | Tauira 8).

How is the employee's benefit apportioned under s CE 2(5)?

However, for the purposes of determining the amount of the benefit that is non-residents' foreign-sourced income for the employee under s CE 2(5), the earning period defined in s CE 2(6)(c) is 2 years as the employee's retirement is when their right to future possession of the shares "vests". This is because, upon retiring and being a good leaver under the terms of the ESS, the employee has a present fixed right of future enjoyment of the shares.

The offshore period (when the employee is non-resident and performing services offshore) under s CE 2(6)(b) is also 2 years. This means the entire benefit is treated as non-residents' foreign-sourced income and is not assessable to the employee in New Zealand.

Example | Tauira 8: Good leaver retaining benefit and being transferred shares from an ESS trust in accordance with ordinary vesting schedule

Employer Co, a New Zealand resident company, has an employee who is not a tax resident in New Zealand and performs their employment duties in Germany such that their services give rise to a foreign-sourced amount of income. The employee purchases 1,000 shares in Employer Co by paying an acquisition price equal to 50% of market value at the time. Under the terms of the ESS, a trustee holds the shares for a period of 3 years. At the end of the 3 years, if the employee is still with Employer Co they will be transferred the shares. If the employee leaves Employer Co before the end of the 3 years as a "bad leaver" (defined in the ESS as being where they leave other than as a good leaver), the shares are transferred back to Employer Co for an amount equal to their cost. If they are a "good leaver" (defined in the ESS as being where they

leave due to retirement, disability or death), they do not forfeit their benefit and will be transferred the shares at the end of the 3-year period.

The employee works for 2 years in Germany and then retires to New Zealand. They keep their entitlement and the trustee transfers the 1,000 shares to the employee at the end of 3 years.

When is the SSTD under s CE 7B(1)(a)?

The SSTD under s CE 7B(1)(a) is when the employee retires as a good leaver in this case. This is because the trustee holds the shares for the employee's benefit and, after this point, none of the matters set out in subparas (i) to (iii) could apply to defer the date. In other words, this is when the market value of the shares must be determined for the purposes of calculating the employee's benefit income under s CE 2(1).

How is the employee's benefit apportioned under s CE 2(5)?

The amount of the benefit that is non-residents' foreign-sourced income for the employee under s CE 2(5) is the same as in Example | Tauira 7. Briefly, the earning period defined in s CE 2(6)(c) is also 2 years because the employee's retirement is when their right to future possession of shares "vests". The offshore period (when the employee is non-resident and performing services offshore) under s CE 2(6)(b) is also 2 years. This means the entire benefit is treated as non-residents' foreign-sourced income and is not assessable to the employee in New Zealand.

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Send feedback to | Tukuna mai ngā whakahokinga kōrero ki public.consultation@ird.govt.nz.

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