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INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Deductions for parties to employee share schemes

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This interpretation statement considers what deductions parties to employee share schemes can claim for income tax. Its focus is on employers.

All legislative references are to the Income Tax Act 2007 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 the rules for employer deductions and providing examples to illustrate how those rules apply.

3. This interpretation statement does not consider the implications of any anti-avoidance provisions and 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 connected to 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. Accordingly, the person who might receive shares under an ESS could be either the employee or an associate. This interpretation statement refers to such a person as the "ESS beneficiary" (as also defined in s CE 7C).

6. 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.

7. There are several potential parties to an ESS such as the employer, the ESS beneficiaries, the company issuing the shares (if different to the employer) and the

trustee facilitating the scheme (if there is one). A person can be a party to an arrangement that is an ESS without necessarily being a signatory of the scheme's documents.

8. An amount derived by a person in connection with their employment or service is income under s CE 1(1)(d) if it is a benefit the person received under an ESS. The amount of the benefit is calculated on the share scheme taxing date (SSTD) using the formula in s CE 2(1). Regardless of who the ESS beneficiary is (ie who receives the shares or related rights), it is the employee that receives any employment income from the ESS under s CE 1(1)(d) and s CE 2.

9. Section CE 2 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.
>
> *Definition of items in formula*
>
> (2) In the formula in subsection (1),—
>
> (a) **share value** is the market value of the shares or related rights owned by an employee share scheme beneficiary on the share scheme taxing date, if the share scheme taxing date is not triggered by a transfer or cancellation of the shares or related rights:
>
> (b) **consideration paid** is the amount of consideration paid or payable by an employee share scheme beneficiary in relation to the transfer of the shares or related rights under the employee share scheme:
>
> (c) **consideration received** is the amount of consideration paid or payable to an employee share scheme beneficiary in relation to a transfer or cancellation of the shares or related rights under the employee share scheme, not including relevant shares or related rights under a replacement employee share scheme:
>
> (d) **previous income** is the total amount of income under section CE 1(1)(d) that the employee share scheme beneficiary has in relation to the shares or related rights before the date that is 6 months after the date of Royal assent for the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018 [Being 29 September 2018].
>
> …

10. 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. The SSTD, which is defined in s CE 7B, is essentially the date when the shares are held by or for the benefit of an ESS beneficiary and none of the provisions that defer the date applies or, if the ESS beneficiary's rights are cancelled or transferred to a non-associate prior to this time, the date when that occurs. The SSTD is the subject of another draft interpretation statement currently out for consultation, PUB00364/A: What an ESS is, the taxing date and benefit apportionment.

Deductions for parties to an employee share scheme

11. Section DV 27 governs what deductions persons who are party to an ESS may take. The parties could potentially include, for example, the employer, the employees and (if different from the employer) the company issuing the shares. A trustee could also be facilitating the ESS, however a trustee is generally treated as nominee for the employer or company issuing the shares under s CE 6 (for more information regarding trustees of an ESS, refer to another draft interpretation statement currently out for consultation, PUB00364/C: Trustee of employee share scheme trust treated as nominee.

12. Section DV 27 states:

> **DV 27 Employee share schemes**
>
> *When this section applies*
>
> (1) This section applies when a person is party to an employee share scheme.
>
> *No deduction except as provided by this section*
>
> (2) Except as provided by this section, the person is denied a deduction for an amount of expenditure or loss for an income year incurred in relation to the employee share scheme.
>
> *Interest, establishment and management*
>
> (3) Subsection (2) does not apply to an amount of expenditure or loss to the extent to which the amount relates to—
>
> (a) a loan or interest:
>
> (b) establishing or managing the employee share scheme.
>
> *Deduction under section CE 2(3)*
>
> (4) The person is allowed a deduction for the amount of the deduction they are allowed under section CE 2(3) (Benefits under employee share schemes) for the income year.

Employment income

(5) The person is allowed a deduction for an amount of expenditure or loss incurred on employment income other than under section CE 1(1)(d) (Amounts derived in connection with employment).

Deduction for benefit

(6) If the person is the employing or contracting company for an employee share scheme beneficiary described in section CE 7(a)(i) or (ii) (Meaning of employee share scheme) (the **employee**), the person has an amount of expenditure or loss calculated using the formula in subsection (7).

Formula

(7) For the purposes of subsection (6), the amount of the expenditure or loss is the positive amount calculated using the formula—

employee amount – previous deductions.

Definition of items in formula

(8) In the formula,—

(a) **employee amount** is the amount for the employee calculated under the formula in section CE 2(1):

(b) **previous deductions** is the total amount of deductions that have been allowed to a party to the employee share scheme or an associate for expenditure or loss incurred—

(i) in relation to the employee amount; and

(ii) before the date that is 6 months after the date of Royal assent for the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018.

Income

(9) A negative amount calculated using the formula in subsection (7) is an amount of income of the person.

Link with subpart DA

(10) Subsection (4) supplements the general permission. Subsection (4) overrides the employment limitation.

13. As set out in s DV 27(2), a party to an ESS is denied a deduction for any expenditure relating to ESS except as provided for by s DV 27. For example, expenditure to acquire shares for the purposes of the ESS is not deductible as it is not provided for in s DV 27.

14. Section DV 27(3) provides that subs (2) does not apply to an amount of expenditure to the extent that it relates to a loan or interest, or establishing or managing the ESS. This means deductions for that expenditure may still be available in accordance with ordinary principles.

15. An employer is also allowed a deduction under s DV 27(5) for expenditure on employment income that is not a benefit under an ESS. For example, this might include the payment of a bonus that is used to subscribe for employer shares.

16. Section DV 27(6) provides that an employer has an amount of expenditure or loss for an employee as calculated under s DV 27(7). Under s DV 27(7), the amount of the "expenditure" is calculated by reference to the employee's benefit and does not involve an outlay by the employer in the normal sense. This subsection only applies to the employer and not to any other party involved in the ESS. For example, it does not apply to a group company issuing the shares under the ESS if that company is not the employer. Expenditure or loss under s DV 27(6) is explained further from [22].

17. Section DV 27 also addresses where a deduction might be available for the employee as a party to an ESS. An employee may have a deduction under s DV 27(4) where an ESS beneficiary has paid more than the market value of the shares on the SSTD.

18. Usually, a person is allowed a deduction for an amount of expenditure or loss to the extent that it meets the general permission in s DA 1. The six general limitations set out in s DA 2 override the general permission and the result can be that expenditure that meets the general permission is not deductible.

19. However, some provisions in the Act supplement the general permission or override a general limitation. Section DA 3 describes how specific rules in Part D affect the general rules. In summary, a provision in Part D may supplement the general permission, meaning that it is not necessary to satisfy the general permission, by expressly stating that it is supplementing the general permission. However, the general limitations may still apply unless the provision expressly overrides them. If a provision in Part D is to override the general permission and/or any one or more of the general limitations, the provision must expressly state that it does so.

20. For items of expenditure or loss referred to in s DV 27, only the potential deduction for employees under s DV 27(4) supplements the general permission and overrides one of the general limitations (the employment limitation). This is expressly provided for in s DV 27(10). None of the other items of expenditure or loss referred to in s DV 27 supplements the general permission or overrides any general limitations.

21. See [27] to [61] for more information on the general permission and general limitations.

Employer treated as having expenditure or loss under s DV 27(6)

22. Section DV 27(6) provides that an employer has an amount of expenditure or loss equal to the positive amount calculated in accordance with the following formula in s DV 27(7):

employee amount – previous deductions

23. The terms used in the formula are defined in s DV 27(8) as follows:

- "Employee amount" is the amount for the ESS beneficiary calculated under the formula in s CE 2(1). Section CE 2(1) (ie calculation of the employee's benefit) is set out and discussed from [8] to [10].
- "Previous deductions" is the total amount of deductions that have been allowed to a party to the ESS or an associate for expenditure or loss incurred in relation to the employee amount on or before 29 September 2018 (which is the date that is 6 months after the amending legislation was enacted). This element of the formula will become less relevant over time.

24. Accordingly, an employer's expenditure or loss under s DV 27(6) is linked to the amount of the employee's benefit as both use the formula in s CE 2(1) as an element in their respective calculations.

25. The result of s DV 27(6) and (7) is that an employer is treated as incurring an amount of expenditure that is generally equal to the amount of the employee's benefit. The formula provided in s DV 27(7) is not dependent on the employer incurring any expenditure in the ordinary sense. Accordingly, the employer does not incur any expenditure in the way it does when it pays salaries and wages. The amount of expenditure or loss may arise for the employer even when a different member of the group is the one issuing shares under the ESS.

26. Example | Tauira 1 illustrates the situation where a New Zealand parent issues shares to employees of a foreign subsidiary. Example | Tauira 2 illustrates the situation where a foreign parent issues shares to employees of a New Zealand-resident employer.

Amount must be deductible under ordinary principles

27. As explained from [18] to [20], s DV 27(6) does not supplement the general permission or override any general limitations for employers. Accordingly, while s DV 27(6) deems the employer to have an amount of expenditure or loss as calculated under the formula in subs (7), the employer must still satisfy the general permission in s DA 1 and

not be subject to the general limitations in s DA 2 to obtain a deduction for that deemed expenditure or loss.

28. Section DA 1 states:

> **DA 1 General permission**
>
> *Nexus with income*
>
> (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
>
> (a) incurred by them in deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income; or
>
> (b) incurred by them in the course of carrying on a business for the purpose of deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income.
>
> *General permission*
>
> (2) Subsection (1) is called the general permission.

29. Section DA 1(1)(a) provides for the deductibility of expenditure that is incurred in deriving assessable income (or excluded income, or a combination of the two). Section DA 1(1)(b) provides for the deductibility of expenditure incurred in the course of carrying on a business for the purpose of deriving assessable income (or excluded income, or a combination of the two).

30. The first limb therefore requires a nexus with the deriving of assessable or excluded income, and the second requires a nexus with the carrying on of a business. The nexus, or degree of connection, required to satisfy each of the two limbs of deductibility is the same, although it is measured in different contexts, namely non-business and business (*NRS Media Holdings v C of IR* (2018) 28 NZTC ¶23-079).

31. It is a matter of degree, and so is a question of fact, to determine whether a sufficient relationship exists between the expenditure and the derivation of income, or the carrying on of a business for the purpose of deriving income. The phrase “the occasion of the loss or outgoing should be found in whatever is productive of the assessable income” is helpful in both characterising the factual inquiry that the application of the statutory language requires and describing the nexus that is the focus of that inquiry

(*CIR v Banks* (1978) 3 NZTC 61,236 (CA), *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA), *NRS Media Holdings*, *Ronpibon Tin NL v FCT* (1949) 78 CLR 47).

32. In the context of expenditure or loss that s DV 27(6) effectively deems to be incurred for an amount calculated under s DV 27(7), there is no item of expenditure that can be examined in the way a usual outlay can. We consider that it must be determined whether a sufficient relationship exists between the provision of the benefit under the ESS (which is what gives rise to the deemed expenditure) and the derivation of the employer's income. Example | Tauira 1 illustrates a situation where the employer would not be able to claim a deduction.

33. If an amount of expenditure or loss satisfies the general permission, in order to be deductible it must also not be subject to any of the general limitations in s DA 2 because they override the general permission. Section DA 2 states:

> **DA 2 General limitations**
>
> *Capital limitation*
>
> (1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the capital limitation.
>
> *Private limitation*
>
> (2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the private limitation.
>
> *Exempt income limitation*
>
> (3) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the exempt income limitation.
>
> *Employment limitation*
>
> (4) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the employment limitation.
>
> *Withholding tax limitation*
>
> (5) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-resident passive income of the kind referred to in section RF 2(3) (Non-resident passive income). This rule is called the withholding tax limitation.
>
> *Non-residents' foreign-sourced income limitation*
>
> (6) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-residents' foreign-sourced income. This rule is called the non-residents' foreign-sourced income limitation.

> *Relationship of general limitations to general permission*
>
> (7) Each of the general limitations in this section overrides the general permission.

34. In the context of an ESS, the "capital limitation" set out in s DA 2(1) that denies a deduction to the extent the expenditure or loss is of a capital nature may be the most relevant general limitation. We discuss the capital limitation in more detail from [35].

The distinction between capital and revenue expenditure

35. Two general principles form the basis for the distinction between capital and revenue expenditure. Dixon J formulated these principles in *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 (HCA) at 647 and 648:

> … the contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organization and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it.
>
> ….
>
> What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical or business point of view rather than on the juristic classification of any legal rights secured, employed or exhausted in the process.

36. In *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948, the Privy Council applied the distinction between capital and revenue drawn in *Hallstroms*. Viscount Radcliffe stated at 960:

> Again courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve …

37. Various cases have considered whether employee-related costs are of a revenue or capital nature. Relevantly, the Full Federal Court of Australia recently considered payments to cancel share entitlements of employees and whether the expenditure was of a capital nature in *Clough Ltd v FC of T (No 2)* 2021 ATC 24,801. We discuss the circumstances of *Clough* from [38], before turning to other case law (from [53]) that may be relevant to employee-related costs.

Clough

38. In *Clough*, among other reasons, the Full Federal Court of Australia held that payments to terminate existing share entitlements (shares and options) of employees to facilitate a takeover of Clough were capital in nature and not deductible by the employer. There was no evidence that the payments were to reward employees.

39. To attract and retain employees, Clough implemented an option plan and an incentive scheme. If employees met certain performance criteria, the option plan entitled them to receive shares. The incentive scheme entitled employees to receive shares or cash at Clough's discretion after 3 years.

40. Clough was listed on the Australian stock exchange. Murray and Roberts (M&R), the majority shareholder in Clough, wanted to acquire all the shares in Clough through a scheme implementation agreement (SIA). The proposed acquisition meant that the rights in the option plan and incentive scheme had to end. Employees could not hold shares in Clough if M&R's objective was to own 100% of Clough.

41. Under the option plan, a change of control event (such as M&R's acquisition of the Clough shares from the minority shareholders) allowed the board to declare that the options could vest immediately even if the performance criteria were not met. Under the incentive scheme, the employees' rights to receive shares or cash would vest automatically under the change of control event (even if the employees did not meet the 3-year vesting period).

42. Both Clough and M&R assumed there was an obligation to pay employees for the accrued entitlements they held in the option plan and incentive scheme. The SIA required Clough to use its best endeavours to cancel options and rights held by employees. (The alternative to cancelling was to allow the options and rights to vest early under the option plan and incentive scheme, enabling employees to acquire shares for sale to M&R under the SIA.)

43. Clough made offers to all its employees (outside of the terms of the option plan and incentive scheme) to cancel their options and rights based on a calculation of what their options and rights would be if they vested immediately under the prevailing share price. The offers were conditional on the SIA becoming effective. The employees accepted the offer.

44. The SIA was implemented on 11 December 2013. The options and rights were cancelled on that day, payments totalling approximately A$15 million were made to employees, M&R acquired the minority shareholding in Clough, and Clough was delisted from the Australian stock exchange.

45. The Full Federal Court of Australia held the payments were capital in nature, and not incurred in gaining or producing assessable income (nor in carrying on a business for the purpose of doing so) under the general deductibility provisions of the Australian

Income Tax Assessment Act 1997 (Cth). This was because the occasion for the expenditure lay in the corporate takeover and not in gaining or producing assessable income and were not in the nature of a working expense in the carrying on of the taxpayer's business. The payments were made to facilitate a takeover to secure 100% ownership by M&R, and were not directed to retaining or incentivising employees. Thawley J stated at [18]:

> 18. Questions of characterisation are ones about which minds often differ. The difficulty this case presents is that the payments were made both to facilitate a change in control of Clough and also to honour legal or commercial obligations to employees arising out of the fact that Clough had granted options and rights to its employees in the course of running its business and for the purpose of rewarding and incentivising those employees. For the reasons which follow, in a practical business sense, the payments are better characterised as payments made pursuant to an agreement to secure a change in control rather than as meeting employee entitlements on a change of control … The rights were granted to the employees in gaining or producing assessable income. However, the occasion of the outgoings lay in the takeover and the object behind making the payments was the bringing to an end of the employees' rights, at the one time, to facilitate the takeover by Murray & Roberts and the delisting of Clough.

46. From [87] to [92], Thawley J concluded the payments were capital in nature for the following reasons:

- The immediate advantage that Clough sought by making the payments was to bring the various options and rights to an end permanently. The object in making payments was to complete M&R's takeover of the minority shareholding in Clough.
- The bringing of the options and rights to an end had an effect on the capital structure of Clough by removing the options and rights as securities on issue.
- Clough cancelled the obligations and rights in performance of its obligations under the SIA.
- As far as Clough was concerned, the payments were all made at once to secure one enduring change: namely, Clough would become wholly owned by M&R.
- The payments were calculated by reference to the share price, not by reference to time that particular employees had served or by reference to performance criteria they had achieved. The payments were unusual and not in the nature of an ordinary working expense.

47. Thawley J also commented:

- the payments were not in the nature of a working expense in the carrying on of Clough's business and were not by way of reward to the employees (at [86]);

- the payments were not connected with considerations of business operations, efficiency or expediency (distinguishing *W Nevill & Co Ltd v Federal Commissioner of Taxation* (1937) 56 CLR 290) (at [123]); and
- as a whole, the payments were not ones that can properly be regarded as reducing future revenue expenses (distinguishing *W Nevill & Co*) (at [125]).

48. Although *Clough* is an Australian decision and decided under different legislation from New Zealand, it is relevant because it applies conventional capital and revenue principles that are followed in New Zealand, such as in *Hallstroms*.

49. While s DV 27(6) specifically deems an expenditure or loss to arise to an employer from an ESS benefit (which is not the case in Australia), it is likely that *Clough* would be followed in New Zealand because s DV 27(6) does not override the capital limitation. Also, if the options and rights had vested and Clough issued shares to employees, Clough would have had no cost to deduct (unlike in New Zealand). However, this was not a decisive factor in the case.

50. Accordingly, while it will always depend on a close examination of the facts of the particular case, if the same factors key to the outcome in *Clough* arise in the context of an ESS in New Zealand, *Clough* would indicate that a payment in those circumstances would likely be capital in nature.

51. The following factors likely influenced the court's finding in *Clough* that the cancellation payments were capital in nature:
    - The cancellation of the option plan and incentive scheme was required under the SIA and the object of making the payments was to facilitate the takeover of Clough.
    - The cancellation payments were made outside the terms of the option plan and incentive scheme.
    - There was no evidence the cancellation payments were to reward employees.
    - The cancellation payments were not calculated by reference to the length of time particular employees had served or by reference to performance criteria they had achieved.
    - There was no requirement the employees remain employed with Clough as a condition of receiving the cancellation payments.
    - The cancellation payments were not connected with considerations of business operations, efficiency or expediency, or reducing future costs.

52. If one or more of the above factors were different, the court might possibly have reached a different outcome. However, the court did not need to assess the weight of each factor individually (because all the factors supported the capital finding), although it appears the first two factors were significant.

Other case law that may be relevant to employee-related costs

53. Other cases are relevant to the deductibility of employee-related costs.

54. In *Heather (I of T) v PE Consulting Ltd* (1972) 48 TC 293, an employer paid contributions into an employee share trust. The court held the payments were revenue in nature because the scheme provided an incentive for staff to remain employed and it helped recruit new staff. This helped the business run more efficiently.

55. Both *CIR (Hong Kong) v Cosmotron Manufacturing Co Ltd* [1997] STC 1,134 (Privy Council) and *FC of T v Foxwood (Tolga) Pty Ltd* (1981) 35 ALR 1 (High Court of Australia) support the principle that expenditure incurred to meet existing obligations owed to employees is revenue in nature, even if the event crystallising the payment occurs after the business has ceased, or arises from the sale of a business. This is relevant for an ESS if a change of control event (such as a share or asset sale) triggers an accelerated vesting of the ESS benefits.

56. In *Cosmotron*, the Privy Council held that the employer always had an obligation to make severance payments to staff. It did not matter that the payment was triggered by the closure of the business. The purpose of the payment was to employ staff because severance benefits were a necessary condition of inducing staff to work for the taxpayer. Therefore, it was revenue in nature.

57. In *Foxwood*, the High Court of Australia held that a payment by the vendor (taxpayer) of a business to the purchaser to take on accrued holiday pay of employees was deductible by the taxpayer, as the taxpayer was liable for the employees' holiday pay at the time the business was sold. However, the taxpayer could not deduct a payment for accrued long-service leave, as the taxpayer was not liable to the employees for that amount.

58. A discretionary bonus paid on the retirement of a reporter was held to be revenue in nature and deductible in *Smith v Incorporated Council of Law Reporting for England and Wales* (1914) 6 TC 477. This was because there was an expectation the bonus would be paid, and it meant the employer could pay the reporter a smaller salary during their working life.

59. *Maryborough Newspaper Co Ltd v FC of T* (1929) 43 CLR 450 involved the taxpayer paying a 10-year annual pension to induce an editor of a newspaper to resign. The payment was held to be deductible as a revenue expense. Such payments ensured loyalty and efficiency in the newspaper business. The taxpayer realised that treating the editor unfairly could cause newspaper circulation to drop and discourage others from applying for the editor's job.

60. The following are examples of non-deductible expenditure:

- In *Christchurch Press Co Ltd v C of IR* (1993) 15 NZTC 10,206, wages paid to electricians and engineers for installing a printing press were held to be capital in nature and non-deductible. This case shows there is no presumption of symmetry between income and deductions.
- In *CIR v New Zealand Forest Research Institute Limited* (2000) 19 NZTC 15,690 (Privy Council), the taxpayer purchased a business and agreed to assume accrued annual leave entitlements of employees transferred as a reduction in the purchase price of the business. The subsequent payment of the leave by the taxpayer to employees was held to be non-deductible capital expenditure.
- In *Commrs of IR v Anglo Brewing Co Ltd* (1925) 12 TC 803, ex gratia sums paid to employees on closure of a business were held to be non-deductible, because the purpose of the payments was to terminate the employment and wind up the business.
- In *Amalgamated Zinc (de Bavay's) Ltd v FC of T* (1935) 54 CLR 295, the taxpayer contributed to a pension scheme for miners after the company ceased production of zinc concentrate. The payment was held to be non-deductible as the business had ceased.

Conclusion on the distinction between capital and revenue

61. Examples | Tauira 4 to 6 illustrate how the capital limitation might apply in certain scenarios. In any case, the answer will depend on a close examination of the facts and the character of the particular benefit or payment to establish the nature and purpose or effect of the relevant expenditure. Variations or additions to the facts in the examples may give rise to a different answer.

Relationship between employer's expenditure and employee's benefit

62. As set out from [22] to [25], the employer's expenditure or loss calculated under s DV 27(6) to (8) is linked to the amount of the employee's benefit. This is because the formula for calculating the amount of expenditure or loss is the employee amount (being the benefit calculated under the formula in s CE 2(1)) less previous deductions (being deductions allowed for expenditure or loss incurred in relation to the employee's benefit before the reformed rules came into force – ie 29 September 2018). Deductions under the former rules will over time be used up, such that the employer's expenditure or loss under s DV 27(6) will equal the employee's benefit under s CE 2(1) in amount.

63. While the amount of the employer's expenditure or loss under s DV 27(6) is obviously linked to the amount of the employee's benefit under s CE 2(1), whether the

expenditure or loss is deductible to the employer is not linked to whether the benefit is assessable to the employee.

64. The amount of the employer's deduction may be different to the amount of the employee's assessable income because the employer's expenditure or loss under s DV 27(6) is subject to the general permission and general limitations. This may result in apportionment or denial of a deduction. What is relevant to the employer's deduction is the nexus the provision of the benefit has with the employer's assessable or excluded income (as discussed from [27] to [34]).

65. In contrast, the employee's benefit calculated in s CE 2(1) is income under s CE 1(1)(d), and subject to the usual criteria to determine whether it is assessable income under s BD 1. For instance, if it is non-residents' foreign-sourced income, it will not be assessable income under s BD 1(5)(c). This is demonstrated by s CE 2(5), which applies to apportion some or all of the benefit to non-residents' foreign-sourced income where the employee has been non-resident while earning the benefit. More discussion of apportionment is in another draft interpretation statement currently out for consultation, PUB00364/A: What an ESS is, the taxing date and benefit apportionment from [70].

66. This treatment is consistent with the underlying policy of the ESS rules that employers and employees should be neutral as far as possible regardless of whether the remuneration is in the form of cash or shares. If an employer paid cash to a non-resident employee, the expense would be deductible (subject to the general permission and general limitations) even though the amount may not be taxable to the employee in New Zealand. Example | Tauira 3 illustrates situations where a company has a non-resident employee.

Negative amount income for the employer

67. If the result of the formula in s DV 27(7) is negative, income arises for the employer under s DV 27(9). Section CV 20 affirms that income under s DV 27(9) is income of the employer. The result of the formula may be negative if, for example:

   - the employee provides more consideration for the shares than their market value on the SSTD; or
   - the employer has deducted more than the employee amount in respect of the benefit on or before 29 September 2018.

Examples | Tauira

Example | Tauira 1 – New Zealand parent issues shares to employees of foreign subsidiary

Parent Co is a New Zealand resident company that makes widgets. It has a wholly owned subsidiary in the Philippines which operates a call centre. The employees of the subsidiary can qualify for shares in Parent Co under the group's ESS. No consideration is paid by the employees when shares are issued.

Parent Co is a party to an ESS and therefore its deductions in respect of the ESS are subject to s DV 27. While Parent Co issues shares under the terms of the ESS, it does not have an amount of expenditure or loss under s DV 27(6) for the benefits provided to the employees in the offshore subsidiary as it is not the employer. If it has expenditure or loss relating to a loan or interest or establishing or managing the ESS, it may have deductions under ordinary principles.

As the employer, the subsidiary in the Philippines could have an amount of expenditure or loss under s DV 27(6). However, as the benefits are not provided to the employees in the course of the subsidiary deriving assessable or excluded income in New Zealand, s DA 1 would not be satisfied and the amount would not be deductible.

Example | Tauira 2 – New Zealand employees receive shares in foreign parent

Employer Co is a wholly owned New Zealand subsidiary of Parent Co, a company resident in the United Kingdom. Employer Co sells mulching machines and gutter guards in New Zealand.

The group has an ESS where the New Zealand resident employees of Employer Co are issued shares in Parent Co when they meet certain conditions, such as continued employment with Employer Co for 3 years.

Employer Co is a party to an ESS and is the employer. While Employer Co does not issue shares or make any payments under the terms of the ESS, it has expenditure or loss under s DV 27(6) calculated under s DV 27(7) when its employees receive shares from Parent Co. That amount will be deductible under s DA 1 as Employer Co incurs it in carrying on its business to derive assessable income and none of the general limitations in s DA 2 applies.

Example | Tauira 3 – Employer deduction does not depend on whether the employee benefit is assessable

Base facts

Employer Co is a New Zealand resident. It exports to Japan and has an employee to provide after-sales assistance to customers.

On 15 June 2021, Employer Co transfers 1,000 shares worth $1,000 to a trustee on trust for the employee. If the employee leaves Employer Co for any reason during the next 3 years, the shares are forfeited for no consideration. If the employee is still employed by Employer Co on 15 June 2024, the shares are transferred to them. The shares are worth $3 per share on 15 June 2024. The employee does not provide any consideration for the shares.

Scenario 1

The employee lives in Osaka and is not tax resident in New Zealand. They provide the after-sales assistance from their home in Japan.

The employee's income in the year ending 31 March 2025 is $3,000 (being 1,000 shares with a market value of $3 per share). However, as the employee is not tax resident in New Zealand and performs their services outside of New Zealand, all the income is non-residents' foreign-sourced income and is not taxed in New Zealand.

As the employer, Employer Co has expenditure or loss under s DV 27(6) in the year ending 31 March 2025 of $3,000. Employer Co is allowed a deduction in respect of this expenditure because the employment has a sufficient nexus with Employer Co's export business, which satisfies the general permission. This is the case even though the employee has no income tax liability in New Zealand.

Scenario 2

The employee is resident in New Zealand and provides the after-sales assistance from Employer Co's office in Auckland. On 15 June 2023, the employee moves to Japan and ceases to be tax resident in New Zealand. The employee continues providing after-sales assistance to customers from their residence in Japan. This means that the employee is New Zealand resident for 2 of the 3 years of service, and then non-resident for the last year.

The employee's income in the year ending 31 March 2025 is $3,000 (being 1,000 shares with a market value of $3 per share). However, only $1,000 of the employee's income is non-residents' foreign-sourced income and is not taxed in New Zealand. The employee will be taxable on the remaining $2,000 of ESS benefits subject to the terms of the tax treaty between Japan and New Zealand.

As the employer, Employer Co has expenditure or loss under s DV 27(6) in the year ending 31 March 2025 of $3,000. Employer Co is allowed a deduction for this expenditure because the employment has a sufficient nexus with Employer Co's export business, which satisfies the general permission. This is the case even though only a portion of the benefit is taxable in New Zealand to the employee.

Example | Tauira 4 – Share sale requiring an option plan to be wound up

Base facts

On 1 May 2023, Employer Co issues 5 employees 1,000 share options each under an ESS option plan as part of their remuneration package for their normal employment duties.

The options may be exercised at the earlier of 1 May 2026 (after 3 years of employment) and the date of a liquidity event, if the employees remain employed by Employer Co at that date (vesting date).

A liquidity event includes a change of control such as a sale of Employer Co's business or a sale by the shareholders of all the shares in Employer Co.

On the vesting date, the employees can each exercise the 1,000 options and buy 1,000 of Employer Co shares for $1 per share.

The options will lapse if they are not exercised by the employees.

A share sale requiring an option plan to be wound up

On 1 May 2024, the shareholders of Employer Co agree to sell 100% of their shares to a third-party buyer. The sale will settle on 2 April 2025. The sale and purchase agreement (SPA) requires Employer Co to cancel the 5 employees' share options on 1 April 2025, and settlement is conditional on that occurring.

The share price of Employer Co is $3 per share on 1 April 2025.

The 5 employees are not involved in the sale process (such as negotiating the sale or assisting with due diligence).

Employer Co offers to cancel the employees' options for a cash payment of $3,000 to each of them ($15,000 in total) on 1 April 2025. The offer letter states that if they do not accept the cancellation offer, their options will vest and they will receive a cash payment of $2,000 ($10,000 in total) instead of shares under the terms of the option plan.

Employer Co is willing to pay the 5 employees an extra $1,000 each as it wants to ensure the options are cancelled, as required under the SPA.

The 5 employees are not required to remain employed by Employer Co as a condition of receiving the payment.

The employees accept the offer, Employer Co pays them $15,000 on 1 April 2025 and the options are cancelled.

The capital limitation in s DA 2(1) is likely to apply to Employer Co for the $15,000 payment, as it appears capital in nature. The following reasons support this conclusion:

- The purpose of the payment is to effect the sale of the shares (despite Employer Co's obligations to employees under the option plan).
- The SPA requires cancellation of the option plan and is conditional on that occurring.
- The payment arises from the SPA and is paid outside the terms of the option plan.
- The amount of the payment does not reflect the terms of the option plan.
- There is no evidence the payment is a reward for employment services.
- The payment does not incentivise the employees to remain employed by Employer Co.

Example | Tauira 5 – Accelerated vesting of options triggered by a share sale

The same **base facts** as set out in Example | Tauira 4 apply. However, instead of a share sale requiring an option plan to be wound up, an accelerated vesting of options is triggered by a share sale as set out below.

On 1 May 2024, the shareholders of Employer Co agree to sell 100% of their shares to the third-party buyer on 2 April 2025. The SPA provides that any unvested options of employees must be cancelled before settlement.

The sale triggers a liquidity event and the options vest. The 5 employees exercise the options on 1 April 2025 and each acquires 1,000 shares at $1 each. Their shares are sold to the buyer on 2 April 2025.

The 5 employees are not involved in the sale process and the purchase price of the shares is not affected by the option plan.

The share price of Employer Co is $3 per share on 1 April 2025.

The ESS income arising to each employee on exercise of the options is $2,000 each ($3,000 share value less $1,000 cost). The total ESS income to 5 employees is $10,000.

Employer Co has $10,000 of deemed expenditure (s DV 27(6)).

The capital limitation in s DA 2(1) is unlikely to apply to Employer Co for the $10,000 expenditure, as it does not appear to be capital in nature. The following reasons support this conclusion:

- Although the sale of the shares triggers an early vesting of the options, Employer Co's obligation to issue shares to the employees for $1 each arises by reason of employment of the employees until the liquidity event, and the delivery of the shares in fulfilment of that obligation will be revenue in character.
- That obligation existed before the sale of Employer Co's shares, and the option plan incentivises employees to stay employed with Employer Co for at least 3 years (or until a liquidity event occurs).
- The SPA's requirement that Employer Co must cancel any unvested options on settlement does not change the above outcome, because the options will vest, and lapse if not exercised, irrespective of the SPA obligation.

Example | Tauira 6 – Cancellation payment in lieu of an accelerated vesting of options triggered by an asset sale

The same **base facts** as set out in Example | Tauira 4 apply. However, instead of a share sale requiring an option plan to be wound up, a cancellation payment is made in lieu of an accelerated vesting of options triggered by an asset sale as set out below.

On 1 May 2024, Employer Co agrees to sell its business and assets to a third-party buyer. The sale will occur on 2 April 2025. The 5 employees will transfer to the buyer. As it is an asset sale, the SPA does not require Employer Co to cancel the share options, and Employer Co's obligations under the option plan do not affect the purchase price of the business.

The share price of Employer Co is $3 per share on 1 April 2025.

The 5 employees are not involved in the sale process. Employer Co offers to cancel the employees' options for a cash payment of $2,000 to each of them ($10,000 in total) on 1 April 2025. The offer letter states that the payment is to meet Employer Co's obligations under the option plan. If the employees do not accept the cancellation

offer, their options will vest and Employer Co will issue shares to them. They will receive ESS income of $2,000 each on exercise of the options.

The employees accept the offer. Employer Co pays them $10,000 in total on 1 April 2025 and their options are cancelled.

The capital limitation in s DA 2(1) is unlikely to apply to Employer Co for the $10,000 payment, as it does not appear to be capital in nature. The following reasons support this conclusion:

- The payment is to meet Employer Co's obligations under the option plan, even if it is triggered early by the sale.
- That obligation existed before the sale, and the option plan incentivises employees to stay employed with Employer Co for at least 3 years (or until a liquidity event occurs). The payment is not made to terminate Employer Co's business, therefore deductibility is not affected by Employer Co's business ceasing.
- Employer Co did not need to cancel the options. It could have let the options vest under the change of control provisions.

Draft items produced by the Tax Counsel Office represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, or practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

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

References | Tohutoro

Legislative references | Tohutoro whakatureture

Income Tax Act 2007, ss BD 1, BG 1, CE 1, CE 2, CE 7 ("employee share scheme"), CE 7B, CE 7C ("employee share scheme beneficiary"), CV 20, DA 1, DA 2, DA 3, DV 27, GB 49B, YA 1 ("arrangement")

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Other references | Tohutoro anō

PUB00364/A: What an ESS is, the taxing date and benefit apportionment. Draft interpretation statement under consultation

PUB00364/C: Trustee of employee share scheme trust treated as nominee. Draft interpretation statement under consultation

About this document | Mō tēnei tuhinga

Interpretation statements are issued by the Tax Counsel Office. They set out the Commissioner's views and guidance on how New Zealand's tax laws apply. They may address specific situations we have been asked to provide guidance on, or they may be about how legislative provisions apply more generally. While they set out the

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