

**EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY | HUKIHUKI HURANGA  
- MŌ TE TĀKUPU ME TE MATAPAKI ANAKE**

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Send feedback to | Tukuna mai ngā whakahokinga kōrero ki  
[public.consultation@ird.govt.nz](mailto:public.consultation@ird.govt.nz)

Notes | Pitopito kōrero: This interpretation statement concludes that a cash-settled ESS benefit is an “extra pay” under the general definition of extra pay, regardless of whether an election to withhold PAYE in respect of the benefit is made. This reflects the current law. However, the Commissioner acknowledges that advice on Inland Revenue’s website may give the impression that the election to withhold PAYE applies to both cash- and share-settled ESS benefits (rather than only share-settled ESS benefits). For that reason, we are proposing this interpretation statement will apply prospectively to cash-settled ESS benefits in accordance with the [Status of Commissioner’s advice](#) (December 2012). We are interested in learning about any practical difficulties that might arise.

**INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI**

# **Employee share scheme benefits paid in cash – PAYE and KiwiSaver obligations**

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**IS XX/XX**

This interpretation statement explains an employer’s PAYE and KiwiSaver obligations when an employee receives a benefit under an employee share scheme that is paid in cash.

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

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## Summary | Whakarāpopoto

1. An employee share scheme (ESS) benefit is usually provided in **shares**. In this situation, the employer can elect to withhold and pay tax on the share benefit. However, there is no requirement for the employer to withhold tax.
2. The purpose of the election is to simplify tax compliance for the employee. Withholding is not compulsory because of concerns that it may impose additional compliance costs on employers (where the benefit is provided in shares).
3. In some circumstances, an employee may receive **cash** instead of shares under an ESS (a **cash-settled ESS benefit**). The following questions arise when an employee receives a cash-settled ESS benefit:
  - Is the employer required to withhold tax from the benefit (on the basis that a cash benefit is an ordinary extra pay) or does the employer have the choice to withhold as they do if the benefit is provided in shares?
  - Does an employer have KiwiSaver obligations when an ESS benefit is provided in cash?
4. An employee might receive cash under a share scheme in various scenarios, such as the following:
  - The employer can choose to settle scheme awards in either cash or shares under the terms of the scheme.
  - The employee can choose to receive cash instead of shares under the terms of the scheme.
  - The terms of the scheme include flexibility to vary the scheme and pay cash in specific situations (eg when the company is sold or an employee retires).
  - The scheme is a phantom share scheme, where amounts are always paid in cash.
5. The first step is to clarify whether the cash the employee receives is truly a cash-settled ESS benefit. This involves considering two questions:
  - Is the scheme an “employee share scheme”?
  - Does the amount give rise to a “benefit” under an ESS?
6. Broadly, the scheme will be an “employee share scheme” if it is an arrangement with **a** purpose or effect of issuing or transferring shares in a company to an employee. The relevant time to assess this requirement is when the scheme is entered into. The arrangement must also be connected to the employee’s employment or service.
7. A phantom share scheme is an example of a scheme that is not an “employee share scheme” for tax purposes. This is because, under a phantom share scheme, an

employee never becomes a shareholder in the company. The benefits are always paid out in cash. In this case, the amount will generally be an ordinary cash bonus and subject to the usual PAYE rules.

8. A cash amount will give rise to a “benefit” under an ESS if the amount is paid in relation to a transfer or cancellation of shares or related rights under the ESS.
9. An example of an ESS where the cash amount will not generally give rise to a “benefit” under the scheme is where the incentive is paid partly in cash and partly in shares. The part that is paid in cash is likely to be paid in satisfaction of the rights granted under the scheme (ie there is no transfer or cancellation of rights). In this situation, the cash amount will generally be an ordinary cash bonus and subject to the usual PAYE rules.
10. Once it has been established that the amount is a cash-settled ESS benefit, the following outcomes arise:
  - The cash-settled ESS benefit is an “extra pay” under the general definition of extra pay and a PAYE income payment.
  - The employer is required to withhold tax at the applicable extra pay rate (plus the Accident Compensation Corporation earners’ levy if applicable)
11. The employer is not required to make KiwiSaver deductions or employer contributions on a cash-settled ESS benefit. This is because KiwiSaver deductions and contributions are based on an employee’s gross “salary or wages” and a cash-settled ESS benefit is excluded from the definition of “salary or wages” for the purposes of the KiwiSaver Act 2006.
12. The election to withhold tax from an ESS benefit applies only to share-settled benefits (ie non-cash benefits). An employer cannot make an election to withhold tax (or choose not to withhold tax) where withholding is already required. This conclusion reflects the purpose of the legislation (to simplify tax compliance for an employee) and the statutory context (to tax employment income at source).
13. 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.

The above conclusion that a cash-settled ESS benefit is an “extra pay” under the general definition of extra pay, regardless of whether an election to withhold PAYE in respect of the benefit is made, reflects the current law. However, the Commissioner acknowledges that advice on Inland Revenue’s website may give the impression that the election to withhold PAYE applies to both cash- and share-settled ESS benefits (rather than only share-settled ESS benefits). See for instance:

[Paying tax on employee share scheme \(ESS\) benefits \(ird.govt.nz\)](#)

[Receiving employee share scheme \(ESS\) benefits \(ird.govt.nz\)](#)

For that reason, we are proposing this interpretation statement will apply prospectively to cash-settled ESS benefits in accordance with the [Status of Commissioner's advice \(December 2012\)](#). We are interested in learning about any practical difficulties that might arise.

## Introduction | Whakataki

### Overview of the issues

14. Most employment income or benefits are taxed at source under the PAYE or FBT rules. However, as a general rule employee share scheme (ESS) benefits are treated differently. While employers must report the value of the benefit in their employment income information (with an exception for some former employees), they generally have a choice about whether to withhold tax under the PAYE rules. Accident Compensation Corporation (ACC) earners' levies and KiwiSaver obligations do not generally apply to ESS benefits.
15. An ESS benefit is usually provided in shares. It is clear how the PAYE rules work in relation to share-settled benefits. However, in some circumstances an employee may receive cash instead of shares. An issue arises as to whether an employer is required to withhold tax from a cash benefit (on the basis that a cash benefit is an ordinary extra pay) or has the choice to withhold as they do if the benefit is provided in shares. A related question is whether an employer has KiwiSaver obligations when an ESS benefit is provided in cash.
16. This interpretation statement explains the Commissioner's position on those issues. It also considers the circumstances in which a cash payment provided to an employee under an ESS is a cash-settled ESS benefit. The statement considers the following three questions:
  - What is a cash-settled ESS benefit?
  - Is an employer required to withhold tax from a cash-settled ESS benefit?
  - What are an employer's KiwiSaver obligations for a cash-settled ESS benefit?

17. This statement only applies where the person receiving the benefit is an employee (under a contract of service).<sup>1</sup> It considers an employer's PAYE (including the ACC earners' levy) and KiwiSaver obligations. Other obligations such as Student Loan or Child Support deductions may also apply but are not considered here.

## Assumptions in this interpretation statement

18. This interpretation statement focuses on whether a cash benefit received under an ESS is treated differently for PAYE and KiwiSaver purposes to a benefit received in shares. For clarity and simplicity, where a technical requirement is not directly relevant to answering this question, it is assumed that the requirement has been met or does not apply. This statement will explicitly state where such assumptions have been made.

## What is a cash-settled employee share scheme benefit?

19. This interpretation statement uses the term "cash-settled ESS benefit" to describe a benefit received under an ESS that is provided in cash rather than shares.
20. Broadly, an employee might receive cash in the following situations:
- The employer can choose to settle scheme awards in either cash or shares under the terms of the scheme.
  - The employee can choose to receive cash instead of shares under the terms of the scheme.
  - The terms of the scheme include flexibility to vary the scheme (including to cancel awards for market consideration in cash) in specific situations (eg when the company is sold or an employee retires).
  - The scheme is a phantom (or shadow) share (or option) scheme.<sup>2</sup>
21. When considering an employer's PAYE and KiwiSaver obligations, it is necessary to understand the nature of the income received. In the case of a cash-settled ESS benefit, it is important to be sure that the cash amount received is in fact a benefit received under an ESS and not, for example, a cash bonus.

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<sup>1</sup> It does not consider the treatment of cash-settled ESS benefits provided to an independent contractor, for example, a non-executive director.

<sup>2</sup> A phantom share scheme can operate in a variety of ways, but the key point is that the employee does not become a shareholder in the company. The benefits of a phantom share scheme are paid out in cash.

22. A benefit received under an ESS is income under s CE 1(1)(d), while a cash bonus is income under s CE 1(1)(a).

**CE 1      Amounts derived in connection with employment**

*Income*

(1)      The following amounts derived by a person in connection with their employment or service are income of the person:

        (a)      salary or wages or an allowance, bonus, extra pay, or gratuity;

        ...

        (d)      a benefit received under an employee share scheme:

        ...

23. The requirements for an amount<sup>3</sup> to be income under s CE 1(1)(d) are that the amount:
- must be derived in connection with the employment or service of the person;
  - must be received under an “employee share scheme” as defined in s CE 7; and
  - must give rise to a “benefit” under s CE 2.
24. The first requirement applies to all amounts that are income under s CE 1(1) (eg salary or wages, a bonus, extra pay or gratuity). It is not directly relevant to the question of whether a cash benefit is an ESS benefit or something else, for example a bonus. This statement assumes that the cash payment in question is derived in connection with an employee’s employment.
25. The second and third requirements determine whether the amount is a benefit received under an ESS and these are set out below.

## Is the amount received under an “employee share scheme”?

26. “Employee share scheme” is defined in s CE 7.

**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—

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<sup>3</sup> An amount includes an amount in money’s worth (s YA 1).

- (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.

27. When a person receives cash instead of shares under an incentive scheme, the key issue is whether the scheme is "an arrangement with a purpose or effect of issuing or transferring shares" in a company to a person (s CE 7(a)). The relevant questions are:
- Is there an arrangement?
  - Does the arrangement have a purpose or effect of issuing or transferring shares in a company to a person?
28. Whether the amount received is cash rather than shares does not affect the other requirements of the definition of "employee share scheme". Therefore, this statement assumes the other requirements of the definition of "employee share scheme" are met. That is:
- the person will be, is or has been an employee (or shareholder-employee) of the company or of another company in the same group (or is an associate of the employee or shareholder-employee);
  - the arrangement is connected to the person's employment or service; and
  - none of the exclusions in s CE 7(b) apply.



29. For simplicity, where this interpretation statement refers to an employee, it includes a shareholder-employee or an associate of the employee or shareholder-employee in question (unless otherwise stated).

## Is there an arrangement?

30. An “arrangement” is defined in s YA 1:

**Arrangement** means an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect.

31. The use of the term “arrangement” in the definition of “employee share scheme” covers all aspects of a scheme, for example, direct transfers of shares, loans to buy shares, bonuses, put and call options, and transfers to trusts.<sup>4</sup>
32. An ESS will ordinarily be an “arrangement” and will typically consist of more than one document, for example, an offer letter, an acceptance form and the share scheme rules.

## Does the arrangement have a purpose or effect of issuing or transferring shares in a company to a person?

33. When cash is received instead of shares under an incentive scheme, the key issue is whether the arrangement has a **purpose or effect** of issuing or transferring shares in a company to a person.
34. The courts have considered the words “purpose or effect” in a tax avoidance context.<sup>5</sup> The following are the main points from those cases that are relevant to an ESS:
- The courts tend to treat the phrase “purpose or effect” as a composite term. That is, although presented as alternatives, the words do not have any real difference in meaning because the purpose is deduced from the effect.
  - The purpose or effect of an arrangement is determined objectively. The subjective motives, intentions or purposes of the parties are not relevant.
  - The objective purpose of the arrangement is determined by considering the intended effect of the arrangement (or the effect that the arrangement sought to achieve).

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<sup>4</sup> **Employee share schemes** *Tax Information Bulletin* Vol 30, No 5 (June 2018): 53

<sup>5</sup> For more on the meaning of “purpose or effect”, see **IS 23/01: Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007** *Tax Information Bulletin* Vol 35, No 2 (March 2023).

- The effect of an arrangement must be ascertained from the terms of the arrangement.
  - The analysis does not depend on hindsight. The relevant time to consider the purpose or effect of an arrangement is the time the arrangement was entered into. The arrangement is not judged on the basis of what actually happened afterwards.
35. Following this approach, the starting point is to consider the terms of the arrangement in order to see what the effect of the arrangement is (ie what it does). This is considered at the time the arrangement is entered into and does not depend on hindsight. The effect of the arrangement will be its objective purpose.
36. In an **ordinary share scheme** where an employee receives shares on vesting or when options are exercised, the effect of the terms of the arrangement is that shares will be transferred (or issued) to the employee. The purpose is the intended effect (or the effect the arrangement seeks to achieve). In this case, the arrangement is an ESS (assuming the conditions of s CE 7(a)(i) to (iii) are met and none of the exclusions in s CE 7(b) apply).
37. In the situation where the terms of a scheme mimic those of an ordinary share or option scheme but **the incentive is always paid in cash**, the arrangement clearly does not have a purpose or effect of transferring or issuing shares. This type of arrangement is commonly referred to as a phantom share scheme and is not an ESS for tax purposes. See Example | Tauria 1.
38. In the situation where the terms of the arrangement provide for the award to be settled **partly in shares and partly in cash, an** intended effect of the arrangement is to transfer shares to the employee. A purpose of the arrangement is therefore also to transfer shares to the employee. The use of the word "a" before "purpose or effect" in s CE 7(a) shows that transferring shares does not have to be the sole or even principal purpose or effect of the arrangement. See Example | Tauria 2.
39. In the situation where the terms of the arrangement allow for the award to be settled in **cash or shares** on vesting at the discretion of the employer, the intended effect of the terms of the arrangement is to transfer either cash or shares. This means there is a purpose of transferring shares. See Example | Tauria 3 and Example | Tauria 4.
40. Another situation that commonly arises is where the terms of the arrangement state that an employee will receive shares on vesting (or when an option is exercised) but the agreement also allows for an employer to **cancel the rights and provide cash** based on the market value of the shares in certain circumstances (eg on the sale of the company or retirement of an employee). Here, the effect of the terms of the arrangement is that shares will be transferred to the employee in the normal course of events. Although the terms of the arrangement also contemplate that shares may not be transferred to an employee in certain circumstances, this possibility does not
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prevent the arrangement from having a purpose or effect of transferring shares to an employee. See Example | Taura 7 and Example | Taura 8.

41. Generally, if the terms of the arrangement allow for the employer to issue shares, the arrangement will have a purpose or effect of issuing or transferring shares even in circumstances where shares are not in fact issued.

## Does the cash payment give rise to a “benefit” under s CE 2?

42. The third requirement for an amount to be income under s CE 1(1)(d) (a benefit received under an ESS) is that the amount gives rise to a “benefit” under s CE 2. Section CE 2 determines the value and timing of a benefit received under an ESS.
43. The items included in the formula for determining the value of the benefit are defined. If the cash amount received is not an item defined in the formula, then it will not give rise to a benefit under an ESS and will not be income under s CE 1(1)(d).
44. The value of a benefit under an ESS is determined under s CE 2(1) and (2).

### 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.

...

45. For a cash amount to give rise to a benefit, the cash received by the ESS beneficiary must be an amount of “consideration received” in the ESS benefit formula. That is, the cash must be paid or payable in relation to a transfer or cancellation of shares or related rights under the ESS (s CE 2(2)(c)).
46. Not all cash paid to an employee under an ESS will give rise to an ESS benefit. One example is where an employer pays a bonus to cover the employee’s tax liability in relation to a share-settled ESS benefit. Although the bonus might be part of the ESS arrangement, it is not an amount paid to the employee in relation to a transfer or cancellation of the shares or related rights under the ESS. In other words, it is not “consideration received” (or any other item) in the formula under s CE 2. The cash paid in that situation would not give rise to a benefit under an ESS. It would instead be treated as a bonus or extra pay under s CE 1(1)(a).
47. It is worth noting that the deduction for the employer under s DV 27(5) also expressly identifies that other employment income may arise under an ESS. Section DV 27(5) is intended to preserve a deduction for the cost of paying a bonus where the payment of the bonus is part of the terms of the ESS.<sup>6</sup> Another example is when the employer pays a bonus to facilitate the employee repaying a loan on vesting (where the loan was used to purchase the shares). Section DV 27(5) 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.

...

*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).

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<sup>6</sup> **Employee share schemes** (June 2018) at 64

...

48. In the situation where the terms of an ESS state that an incentive will be paid **partly in cash and partly in shares**, then the part of the incentive that is paid in cash will not generally give rise to a benefit under s CE 2. This is because the cash is not an amount paid in relation to a transfer or cancellation of shares or related rights under an ESS. The cash incentive would be income to the employee under s CE 1(1)(a). The part of the incentive scheme that is settled in shares would give rise to a benefit under an ESS (s CE 2(2)(a)). See Example | Taurira 2.
49. The situation is different where the terms of the ESS allow for the award to be settled in **cash or shares** on vesting at the discretion of the employer and the amount is settled in cash. In this case, whether the cash gives rise to a benefit under an ESS depends on whether there is a transfer or cancellation of shares or related rights granted to the employee. See Example | Taurira 3 and Example | Taurira 4.
50. For an illustration of where an employee receives cash or shares at the employee's discretion, see Example | Taurira 5.
51. In a further situation, an employee may be granted rights or options to acquire shares and the terms of the ESS allow for an employer to cancel the rights or options and provide a cash equivalent in certain circumstances (eg on the sale of the company or retirement of the employee). Here, the cash amount received will give rise to a benefit under an ESS. This is because the cash is paid in relation to a cancellation of rights under the ESS. See Example | Taurira 7 and Example | Taurira 8.
52. For completeness, the amount of the benefit is calculated on the "share scheme taxing date" (s CE 2(1)). "Share scheme taxing date" is defined in s CE 7B:

**CE 7B Meaning of share scheme taxing date**

*Meaning*

- (1) **Share scheme taxing date** means, in relation to shares or related rights under an 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.

- 53. The share scheme taxing date is the earlier of the dates specified in paras (a) and (b) of s CE 7B(1). Paragraph (a) is the date when shares are held by or for the benefit of the ESS beneficiary and there are no provisions in the scheme that would defer that date under subparagraphs (i) to (iii). Paragraph (b) is the date when the shares or related rights are cancelled or transferred to a person who is not associated with the employee (eg the employer).
- 54. For the purposes of this statement, the share scheme taxing date is the trigger that determines whether a benefit under an ESS is received in shares or cash. See Example | Taurira 6 and Example | Taurira 7.

## Summary

- 55. A "cash-settled ESS benefit" is not a defined term. It is a term used in this statement to describe a benefit received under an ESS that is provided in cash rather than shares.
- 56. An amount will be a cash-settled ESS benefit if:
  - an employee receives the amount under an "employee share scheme"; and
  - the amount gives rise to a "benefit" under an ESS.
- 57. Broadly, an amount will be received under an "employee share scheme" if the scheme is an arrangement with a purpose or effect of issuing or transferring shares in a company to an employee. The relevant time to assess this requirement is when the

scheme is entered into. If the terms of the scheme allow for shares to be issued or transferred to an employee, then there will generally be a purpose or effect of issuing or transferring shares even in circumstances where the shares are not ultimately transferred to the employee in question.

58. A cash amount will give rise to a benefit under an ESS if the amount is paid in relation to a transfer or cancellation of shares or related rights under the ESS.

## Is an employer required to withhold tax from a cash-settled employee share scheme benefit?

59. An employer's withholding obligations are set out in s RA 5:<sup>7</sup>

<b>RA 5</b>	<b>Tax obligations for employment-related taxes</b>
	<i>Withholding and payment obligations</i>
(1)	A person who makes a payment or provides a benefit of 1 of the following kinds must either withhold and pay, or pay, the amount of tax for the payment or benefit to the Commissioner under subpart RD (Employment-related taxes) by the due dates:
(a)	a PAYE income payment:
(b)	a fringe benefit:
(c)	an employer's superannuation cash contribution.
	<i>Timing for PAYE income payments</i>
(2)	An amount of tax withheld from a PAYE income payment must be withheld at the time the person makes the payment.

60. An employer is required to withhold and pay (or pay) tax for a PAYE income payment, a fringe benefit and an employer's superannuation cash contribution. An ESS benefit is not a superannuation cash contribution or a fringe benefit.<sup>8</sup> Therefore the question is whether an ESS benefit (and in particular a cash-settled ESS benefit) is a "PAYE income payment". If it is, then an employer will be required to withhold tax from the payment.

61. "PAYE income payment" is defined in s RD 3:

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<sup>7</sup> See also s BE 1(1) (Withholding liabilities – PAYE income payments) and s RD 1 (Employment-related taxes – Introductory provision).

<sup>8</sup> An ESS benefit is excluded from being a fringe benefit because it is included in the assessable income of an employee under s CE 1(1)(d). (See s CX 4.)

**RD 3 PAYE income payments***Meaning generally*

- (1) The PAYE rules apply to a **PAYE income payment** which—
- (a) means—
    - (i) a payment of salary or wages, see section RD 5; or
    - (ii) extra pay, see section RD 7; or
    - (iii) a schedular payment, see section RD 8:
  - (b) does not include—
    - (i) an amount attributed under section GB 29 (Attribution rule: calculation):
    - (ii) an amount paid to a shareholder-employee in the circumstances set out in section RD 3B or RD 3C:
    - (iii) an amount paid or benefit provided, by a person (the **claimant**), who receives a personal service rehabilitation payment from which an amount of tax has been withheld at a rate specified in section RD 10B.

...

62. A PAYE income payment means a payment of salary or wages, an extra pay or a schedular payment.<sup>9</sup>
63. "Salary or wages" (s RD 5) and "extra pay" (s RD 7) are payments made to a person in connection with their employment. Salary or wages are generally regular amounts, and an extra pay is generally a one-off amount. They are defined separately because the amount of tax withheld from an extra pay is calculated differently to PAYE on salary or wages.
64. Because a cash-settled ESS benefit is generally a one-off payment, the starting point is whether it is an extra pay. If an amount is an "extra pay", then it is excluded from being salary or wages (s RD 5).<sup>10</sup>

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<sup>9</sup> This interpretation statement assumes that none of the exclusions in s RD 3(1)(b) apply.

<sup>10</sup> Whether a cash-settled ESS benefit can in some circumstances be a schedular payment is outside the scope of this interpretation statement. This statement only considers cash-settled ESS benefits where the recipient of the benefit is an employee (under a contract of service).



## Is a cash-settled employee share scheme benefit an extra pay?

65. An extra pay is relevantly defined in s RD 7.<sup>11</sup>

RD 7	<b>Extra pay</b>
	<i>Meaning</i>
(1)	An <b>extra pay</b> —
	(a) means a payment that—
	(i) is made to a person in connection with their employment; and
	(ii) is not a payment regularly included in salary or wages payable to the person for a pay period; and
	(iii) is not overtime pay; and
	(iv) is made in 1 lump sum or in 2 or more instalments; and
	(b) includes a payment of the kind described in paragraph (a) made—
	(i) as a bonus, gratuity, or share of profits; or
	(ii) as a redundancy payment; or
	(iii) when the person retires from employment; or
	(iv) as a result of a retrospective increase in salary or wages, but only to the extent to which it accrues from the start of the increase until the start of the first pay period in which the increase is included in salary or wages; and
	(bb) includes a benefit under section CE 1(1)(d) (Amounts derived in connection with employment) in relation to which the employer has made an election under section RD 7B to withhold an amount of tax; and
	...
	(d) does not include a payment of exempt income.
	...

66. Paragraph (a) of s RD 7 sets out the general definition of “extra pay”. It defines what an extra pay **means** for tax purposes. A cash-settled ESS benefit will generally fall within the definition of extra pay for the following reasons:

- It is a payment of cash.

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<sup>11</sup> This statement assumes that a cash-settled ESS benefit is not a payment of exempt income under para (d).

- The payment is made to an employee in connection with their employment. It is a requirement of the definition of “employee share scheme” that the arrangement is connected to the person’s employment or service so this requirement will already have been met.
  - The payment is not a payment regularly included in salary or wages payable to the person for a pay period.
  - The payment is not overtime pay.
  - The payment is made in one lump sum or two or more instalments (ie a payment is still an “extra pay” even if it is not made in one lump sum).
67. Therefore, the starting point is that a cash-settled ESS benefit provided to an employee will generally be an “extra pay” under the general definition of extra pay in s RD 7(1)(a).
68. The amount of the payment is the amount of the benefit in cash under the formula in s CE 2(1). This will generally be the amount paid to the employee for the transfer or cancellation of shares or related rights (which includes a payment for the cancellation of a share option). Sometimes the employee might have paid an amount to acquire shares at the outset. In this situation, the Commissioner considers that the payment will be the net amount of the benefit in cash.
69. For completeness, a share-settled ESS benefit is not an extra pay under s RD 7(1)(a). This is because a “payment” in the context of employment income and the PAYE rules is generally considered to be a sum of money. A share-settled benefit is a non-cash benefit and as such is not a “payment”.
70. Paragraph (b) of s RD 7 gives examples of the types of payments that fall within the general definition of “extra pay”. The words “of the kind” indicate that the list of payments is intended to be illustrative or explanatory rather than exhaustive.<sup>12</sup> The word “includes” here is a further indication that the list is not intended to be exhaustive.<sup>13</sup>
71. Given the payments listed in para (b) are intended to be illustrative rather than exhaustive, the fact that a cash-settled ESS benefit is not specified in para (b) does not prevent it from being an extra pay under para (a).
72. Paragraph (bb) of s RD 7 relates specifically to ESS benefits. It has been suggested that this reference to ESS benefits means that such benefits should not constitute an extra pay as defined unless para (bb) is satisfied. It is helpful to consider how para (bb)

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<sup>12</sup> *Northland Environmental Protection Society Inc v Chief Executive of the Ministry for Primary Industries* [2019] 1 NZLR 257 at [48] considers the words “such as” in a similar context.

<sup>13</sup> R Carter, *Burrows and Carter Statute Law in New Zealand* (6th ed, LexisNexis, Wellington, 2021) at 568

applies to share-settled ESS benefits before considering whether it applies to cash-settled ESS benefits.

## Paragraph (bb) – share-settled benefits

73. For ease of reference, para (bb) is restated here:

<b>RD 7</b>	<b>Extra pay</b>
	<i>Meaning</i>
(1)	An <b>extra pay</b> —
	...
	(bb) includes a benefit under section CE 1(1)(d) (Amounts derived in connection with employment) in relation to which the employer has made an election under section RD 7B to withhold an amount of tax;

74. The requirements for a benefit to be an extra pay under para (bb) are that:
- it must be a benefit under s CE 1(1)(d); and
  - the employer must have made an election under s RD 7B to withhold an amount of tax in relation to the benefit.
75. A share-settled ESS benefit is a benefit under s CE 1(1)(d) (ie a benefit received under an ESS).
76. Section RD 7B sets out when an employer has made an election to withhold tax from an ESS benefit.

<b>RD 7B</b>	<b>Treatment of employee share schemes</b>
	<i>When this section applies</i>
(1)	This section applies for employees or a former employee in relation to benefits under an employee share scheme, if—
	(a) an employer has irrevocably chosen to withhold and pay tax for a benefit for an employee under the scheme in accordance with subsection (3); or
	(b) an employer chooses to withhold and pay tax for a benefit for an employee under the scheme in accordance with subsection (4).
	<i>Irrevocable obligation</i>
(2)	An employer who has made an irrevocable election described in subsections (1)(a) and (3) must comply with subsection (4)(a) to (c) for—
	(a) the relevant benefit and employee under the scheme:

- (b) benefits offered or provided to the employee in replacement of the relevant benefit.

*Irrevocable obligation: form*

- (3) For the purposes of subsection (1)(a), an employer has irrevocably chosen to withhold and pay tax for a benefit for an employee, if it is a term of the offer of the benefit, or of the scheme under which the benefit is provided, that the employer must withhold and pay tax under this section.

*Withholding and paying*

- (4) For the purposes of subsection (1)(b), an employer chooses to withhold and pay tax for some benefits for some employees by—
  - (a) calculating the amounts of tax that must be withheld for the relevant benefits and employees, and paying the amounts to the Commissioner as described in section RD 4(1); and
  - (b) including the amounts in the employer's employment income information under subpart 3C of the Tax Administration Act 1994, treating the relevant ESS deferral date as the relevant payday; and
  - (c) making the disclosure referred to in paragraph (b) within the time required under section RD 6(3)(a).

77. Section RD 7B allows an employer to choose to withhold tax on an ESS benefit provided to an employee. An employer can make the election when the benefit is provided by calculating the amount of tax, paying the tax to Inland Revenue and including the amount of the tax in its employment income information in the timeframe required.
78. Alternatively, an employer can make an irrevocable election to withhold and pay tax on an ESS benefit at the time the benefit is offered. It makes this election by including in the terms of the offer or the scheme that the employer must withhold and pay tax under s RD 7B. The employer must also comply with the withholding and payment requirements of subs (4) of s RD 7B.<sup>14</sup>
79. If an employer has made an election to withhold tax from a share-settled ESS benefit under s RD 7B, then the benefit is treated as an extra pay under s RD 7(1)(bb). As such, it is a PAYE income payment (s RD 3) and subject to the PAYE rules (s RD 2(2)).

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<sup>14</sup> The irrevocable election was introduced to enable employers to meet the requirements to adopt equity-settled accounting treatment for the withheld tax under International Financial Reporting Standards. See **Employee share schemes – withholding obligations** *Tax Information Bulletin* Vol 31, No 8 (September 2019): 85.

**RD 2 PAYE rules and their application***Meaning*

- (1) The **PAYE rules** means—
- (a) section BC 1 (Non-filing and filing taxpayers); and
  - (b) sections LA 6, LB 1, and LD 4 (which relate to tax credits); and
  - (c) sections RD 3 to RD 24; and
  - (d) sections RP 2 to RP 16 (which relate to PAYE intermediaries); and
  - (e) subparts 3C and 3D, sections 22AA, 124H to 124K, 124O to 124Q, 133, Part 9, sections 167 to 169, and schedules 4 and 5 of the Tax Administration Act 1994.

*Application*

- (2) The PAYE rules apply to a person who makes or is required to make a PAYE income payment and, in certain circumstances, to the person to whom the PAYE income payment is made.

...

80. Under the PAYE rules, an employer is required to pay the tax withheld to Inland Revenue and report the value of the benefit and the amount of tax withheld in the employer's employment income information on the relevant date.
81. If the employer has not made an election to withhold tax from a share-settled ESS benefit, then the benefit is not an extra pay or a PAYE income payment. However, the benefit is still income to the employee under s CE 1(1)(d). Under the PAYE rules, the employer is required to report the value of the benefit to Inland Revenue in its employment income information (unless the person is a former employee). A former employee must report the value of the benefit in their tax return themselves. The employee (including if they are a former employee) pays tax on the benefit through the end-of-year tax return process (and through provisional tax if applicable).<sup>15</sup>

**Paragraph (bb) – cash-settled benefits**

82. On first impression, the election to withhold tax on an ESS benefit could also apply to cash-settled benefits. However, as a cash-settled ESS benefit is already an extra pay under s RD 7(1)(a) (from which an employer is required to withhold tax), this raises the question of how ss RD 7(1)(a), RD 7(1)(bb) and RD 7B interact.

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<sup>15</sup> See **QB 23/05: Provisional tax – impact on salary or wage earners who receive a one-off amount of income without tax deducted** *Tax Information Bulletin* Vol 35, No 5 (June 2023)

83. Section 10(1) of the Legislation Act 2019 states that “the meaning of legislation must be ascertained from its text and in the light of its purpose and its context”.<sup>16</sup> It is therefore useful to consider:
- the structure of the definition of extra pay;
  - the history of the introduction of ss RD 7(1)(bb) and RD 7B;
  - the broader statutory context; and
  - the interaction of ss RD 7(1)(a), RD 7(1)(b) and RD 7B.

### **The structure of the definition of “extra pay”**

84. The structure of the definition of “extra pay” uses the words “means”, “includes” and “does not include”. In *Northland Environmental Protection Society*, the Supreme Court described this structure as straightforward and conventional with the “includes” part of the structure extending the general definition in certain respects.

[39] Turning to the wording of the definition of finished or manufactured indigenous timber product, the first point is that this definition has a straight forward and conventional structure. Para (a) contains the general definition. Para (b) extends the definition in certain respects, while para (c) excludes certain categories of items that would otherwise come within paras (a) or (b).

85. Likewise in *Begg v CIR* (2009) 24 NZTC 23,473, the Court of Appeal held (at [18] to [30]) that a definition containing both the words “means” and “includes” enlarges or extends the ordinary meaning of the defined term. This meant that the thing “included” did not need to come within the “means” part of the definition.
86. In *Progressive Meats Ltd v Ministry of Health* [2008] NZCA 162 the Court of Appeal agreed with the District Court judge’s approach that the use of the “means” and “includes” technique in that case gave rise to an extended definition of “workplace”.
87. The case law shows that the usual approach to a “means” and “includes” definition is to interpret the “includes” part of the definition as extending the “means” part to cover things that would not ordinarily come within it. As s RD 7(1)(b) demonstrates, “includes” is also used to give examples of things that come within the “means” definition without the intention that the examples are exhaustive. While these are the normal uses of “includes” in a “means” and “includes” definition, “includes” may have other effects depending on the context.<sup>17</sup>

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<sup>16</sup> For more on s 10(1) of the Legislation Act 2019, see IS 23/01: Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007.

<sup>17</sup> Carter at 570

88. Section RD 7(1)(bb) extends the definition of extra pay to include ESS benefits **in relation to which** an employer has made an election to withhold tax under s RD 7B. The words “in relation to” express a way in which two things are connected. The *Oxford English Dictionary* defines “relation” as follows:<sup>18</sup>
- Relation, n. 2. a.** An attribute denoting or concept expressing a connection, correspondence, or contrast between different things; a particular way in which one thing or idea is connected or associated with another or others; a link, a correlation; the fact of being so connected, associated, etc.; connection, association. Frequently with *to*, *between*, or *with*.
89. In the Commissioner’s view, the use of the words “in relation to” in para (bb) does not limit the general definition of extra pay in para (a). In the context of the history of the legislation, s RD 7(1)(bb) simply extends the meaning of extra pay to include benefits where the employer has elected to withhold tax. It does not prevent a cash-settled ESS benefit from being an extra pay under s RD 7(1)(a).
90. The question is whether an employer has made an election under s RD 7B. On first impression, the election can apply to both cash- and share-settled benefits. However, an indication that the election is intended to apply only to share-settled benefits can be found in s RD 7B(4)(c), which refers to s RD 6(3)(a). Section RD 6(3)(a) applies when an employee receives the benefit otherwise than in cash.

**RD 6      Certain benefits and payments**

*When this section applies*

(1) This section applies when an employee receives—

...

(d) a benefit under section CE 1(1)(d) (Amounts derived in connection with employment) in relation to which the employer has made an election under section RD 7B; or

...

*When non-cash benefit treated as paid*

(3) If the employee receives the benefit otherwise than in cash, the value is treated as paid—

(a) for a benefit referred to in subsection (1)(d), on the ESS deferral date on which the employee is treated as deriving the benefit under section CE 2(8) (Benefits under employee share schemes); or

...

<sup>18</sup> *Oxford English Dictionary* (online edition, Oxford University Press 2023, accessed 22 December 2023)

91. Section RD 7B proceeds on the basis that there is a **choice** to withhold. Likewise s RD 7(1)(bb) refers to an election. In the Commissioner's view, an employer cannot choose or elect to withhold tax in relation to a cash-settled ESS benefit when withholding is already required (because a cash-settled benefit is an extra pay under s RD 7(1)(a)). The election can only apply to a share-settled benefit.
92. It could be argued that an employer always chooses to withhold tax for a cash-settled ESS benefit and therefore a cash-settled benefit will be an extra pay under both paras (a) and (bb) of s RD 7(1). This argument proceeds on the basis that a cash-settled ESS benefit is an extra pay under s RD 7(1)(a) and so an employer will necessarily meet all the requirements of an election under s RD 7B(4). In the Commissioner's view, this argument is circular in nature and the better view is that an employer has not made (and cannot make) an election under s RD 7B for a cash-settled ESS benefit.

### **The history of the introduction of ss RD 7(1)(bb) and RD 7B**

93. The background and legislative history of the introduction of ss RD 7(1)(bb) and RD 7B show the following:
  - The genesis for the changes was that some employers approached Inland Revenue about using the PAYE system to return tax on their employees' behalf.
  - The officials' issues paper **Simplifying the collection of tax on employee share schemes** (Inland Revenue, April 2015) was only concerned with non-monetary ESS benefits.
  - The overarching purpose of the changes was to **simplify tax compliance** for employees. If an employer withholds tax, then the employee should not have additional tax to pay at the end of the year or become a provisional taxpayer as a result of receiving an ESS benefit.
  - Other reasons for the changes were to reduce the risk of non-compliance and minimise Inland Revenue's administration costs. (It is more efficient for tax to be withheld at source.)
  - Withholding was made elective rather than compulsory because Parliament accepted stakeholders' concerns that compulsory withholding may impose additional compliance costs on employers, meaning that taxing ESS benefits at source was not always appropriate or efficient.<sup>19</sup> These concerns apply to share-settled benefits only.

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<sup>19</sup> **Taxation (Transformation: First Phase Simplification and Other Measures) Bill (Regulatory Impact Statements, Policy and Strategy**, Inland Revenue, June 2015) at [61]



94. The legislation achieves its main purpose of simplifying compliance for employees (if the employer elects to withhold tax) in relation to share-settled benefits.
95. However, a cash-settled ESS benefit was already (and still is) an extra pay under the general definition of extra pay and subject to tax at source. New legislation was not necessary to allow an employer to withhold tax from a cash-settled benefit. Applying the legislation so that a cash-settled ESS benefit is **only** an extra pay **if** an election is made would be inconsistent with the main purpose of simplifying compliance for employees. It would result in more employees paying tax on the benefit through the end-of-year tax process and potentially becoming provisional taxpayers.
96. The purposes of reducing the risk of non-compliance and minimising Inland Revenue's administrative costs are also achieved for share-settled benefits (where an election is made) but not for cash-settled benefits.
97. Overall, the history of the introduction of the election to withhold PAYE on ESS benefits shows that it was only intended to apply to non-cash benefits.

### **The broader statutory context**

98. Employment income is generally taxed at source, under either the PAYE or FBT rules. It clearly fits within the scheme of the Act to withhold tax from share scheme benefits that were not previously subject to tax at source (ie share-settled benefits). However, it would be inconsistent with the scheme of the Act for a cash-settled ESS benefit that was previously subject to tax at source to now only be subject to tax at source at the election of the employer.
99. It is also relevant to the integrity of the tax system and perceptions of fairness if some cash amounts received by employees are subject to tax at source and others are only subject to tax at source at the election of the employer.

### **The interaction of ss RD 7(1)(a), RD 7(1)(b) and RD 7B**

100. A cash-settled ESS benefit is an extra pay under the general definition of extra pay (s RD 7(1)(a)). On first impression, it could also be an extra pay under s RD 7(1)(bb) if an employer has elected to withhold tax.
101. In *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36, the Supreme Court stated at [24]:

Where, as here, the meaning is not clear on the face of the legislation, the court will regard context and purpose as essential guides to meaning.

102. In relation to inconsistent provisions, Carter states at 607–608:

Normally it will be found, on reading the Act as a whole, taking into account scheme and purpose, that the two provisions can in fact be read consistently, albeit by “reading down” one of them. Often it will be discovered on such a contextual reading that the reader’s own first impressions of one section have to be modified.

...

Sometimes the reconciliation requires a strained interpretation to be given to one section; the law has always recognised that the avoidance of internal inconsistency can justify some liberality with words. In some such cases it is necessary to decide, in the light of the scheme and purpose of the legislation, which of the two provisions is the dominant one, requiring the other to be read down. ... In determining which of two sections is to have primacy, regard may be had to their purpose, their history, and even their positioning in the Act.

103. Looking at the situation as a whole and considering the purpose of the legislation, the history and the statutory context, the Commissioner considers that s RD 7(1)(bb) extends the definition of extra pay to include share-settled ESS benefits where the employer has elected to withhold tax under s RD 7B. It does not apply to cash-settled ESS benefits that are already an extra pay under s RD 7(1)(a).

## Summary

104. The definition of “extra pay” applies to ESS benefits as follows:
- A cash-settled ESS benefit is an extra pay under the general definition of extra pay in s RD 7(1)(a).
  - Section RD 7(1)(bb) extends the general definition of extra pay to include a share-settled benefit where the employer has elected to withhold tax.
  - An employer cannot (and does not) make an election to withhold tax for a cash-settled ESS benefit.
105. This view is supported by the overarching purpose of the election, which is to simplify tax for employees by allowing an employer to withhold tax at source. It would not be consistent with that purpose if an employer was able to choose not to withhold tax from a benefit where withholding was already required under the Act. This conclusion is also consistent with the scheme of the Act, which is to tax employment income at source.

## ACC earners’ levy

106. An employer’s obligations regarding collecting ACC earners’ levy are set out in the Accident Compensation Act 2001 (ACC Act). An issue related to whether an employer

is required to withhold tax from a cash-settled benefit under the PAYE rules is whether the earners' levy also applies to cash-settled ESS benefits.

107. An employer collects the earners' levy by making a deduction from an employee's "earnings" (s 221 of the ACC Act). "Earnings" includes "earnings as an employee" (s 6 of the ACC Act). "Earnings as an employee" means all PAYE income payments (as defined in s RD 3(1)) of the person for the tax year (s 9 of the ACC Act).
108. Section 11 of the ACC Act excludes from "earnings as an employee" any benefit arising from an ESS under s CE 2 when the employer makes an election under s RD 7B to withhold and pay tax in relation to the benefit.<sup>20</sup>

**11 Earnings as an employee: what it does not include**

- (1) Earnings as an employee, in relation to any person and any tax year, does not include—
- ...
- (cb) any benefit arising from a[n] employee share scheme under section CE 2 of the Income Tax Act 2007 when the employer makes an election under section RD 7B of that Act to withhold and pay tax in relation to the benefit; or
- ...

109. Because a cash-settled ESS benefit is a PAYE income payment, as a starting point it is subject to ACC earners' levy. The question is whether the exclusion in s 11(1)(cb) of the ACC Act applies.
110. A cash-settled ESS benefit is a benefit arising from an ESS under s CE 2. The Commissioner considers that the choice to withhold tax in s RD 7B does not apply to a cash-settled ESS benefit. This is because a cash-settled ESS benefit is an extra pay under s RD 7(1)(a) and a PAYE income payment under s RD 3 from which an employer is required to withhold tax.
111. On the basis that an employer cannot and does not make an election under s RD 7B in relation to a cash-settled ESS benefit, the exclusion in s 11(1)(cb) of the ACC Act does not apply to a cash-settled ESS benefit. This means an employer is required to deduct ACC earners' levy from a cash-settled ESS benefit.
112. This outcome is consistent with the scheme of the Income Tax Act 2007, which is broadly that the ACC earners' levy applies to cash payments made to an employee (subject to the maximum thresholds).

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<sup>20</sup> A similar exclusion applies for shareholder-employees in s 15 of the ACC Act.

113. For completeness, an employer is not required to deduct ACC earners' levy from a share-settled benefit where an employer has elected to withhold tax under s RD 7B.
114. In summary, an employer is required to deduct ACC earners' levy from a cash-settled ESS benefit. This outcome arises because a cash-settled ESS benefit is a PAYE income payment and is not excluded from the definition of "earnings as an employee" under the ACC Act because an employer does not make an election under s RD 7B to withhold tax in relation to a cash-settled ESS benefit.

## Summary

115. A cash-settled ESS benefit is an extra pay and a PAYE income payment. As such, an employer is required to withhold an amount of tax from the payment under the PAYE rules at the appropriate extra pay rate. ACC earners' levy will also apply (subject to the usual maximum thresholds).

## What are an employer's KiwiSaver obligations for a cash-settled employee share scheme benefit?

116. An employer's KiwiSaver obligations are determined under the KiwiSaver Act 2006 (KiwiSaver Act).
117. Broadly, if an employee is a KiwiSaver member and is not on a savings suspension (ie taking a break from making KiwiSaver contributions), then an employer is required to deduct KiwiSaver contributions at the relevant contribution rate from the employee's gross salary or wages.<sup>21</sup> An employer is also generally required to make a compulsory employer contribution based on an employee's gross salary or wages.<sup>22</sup>
118. "Salary or wages" is defined in s 4 of the KiwiSaver Act and relevantly states:

**salary or wages**, in relation to any person, means salary or wages as defined in section RD 5(1)(a) to (c) of the Income Tax Act 2007 (whether the salary or wages are primary or secondary employment earnings) except that, in this Act,—

(a) it excludes—

...

---

<sup>21</sup> See Part 3, subpart 1 (Deductions of contributions from salary or wages) of the KiwiSaver Act.

<sup>22</sup> See Part 3, subpart 3A (Compulsory employer contributions to KiwiSaver schemes and complying superannuation funds) of the KiwiSaver Act.

- (vi) the amount of a benefit that an employee receives under section CE 2 of the Income Tax Act 2007 under an employee share scheme when the amount is treated as an amount of extra pay of the employee:
- (b) it includes extra pay (as defined in section YA 1 of the Income Tax Act 2007), unless—
  - (i) otherwise excluded under paragraph (a) of this definition; or
  - (ii) the amount is a redundancy payment for the purposes of the Income Tax Act 2007.

119. As a starting point, “salary or wages” for KiwiSaver purposes means salary or wages as defined in s RD 5(1)(a) to (c), which relevantly states:

**RD 5      Salary or wages**

*Meaning*

(1)      **Salary or wages—**

- (a)      means a payment of salary, wages, or allowances made to a person in connection with their employment; and
- (b)      includes—
  - ...
- (c)      does not include—
  - ...
  - (ii)      an extra pay:
    - ...

120. “Salary or wages” in s RD 5 does not include an extra pay (s RD 5(1)(c)(ii)). In contrast, para (b) of the definition of “salary or wages” in the KiwiSaver Act includes an extra pay in salary or wages for the purposes of that Act. But it does not include an extra pay that is otherwise excluded from being “salary or wages” under para (a). Paragraph (a)(vi) excludes:

the amount of a benefit that an employee receives under section CE 2 of the Income Tax Act 2007 under an employee share scheme when the amount is treated as an amount of extra pay of the employee:

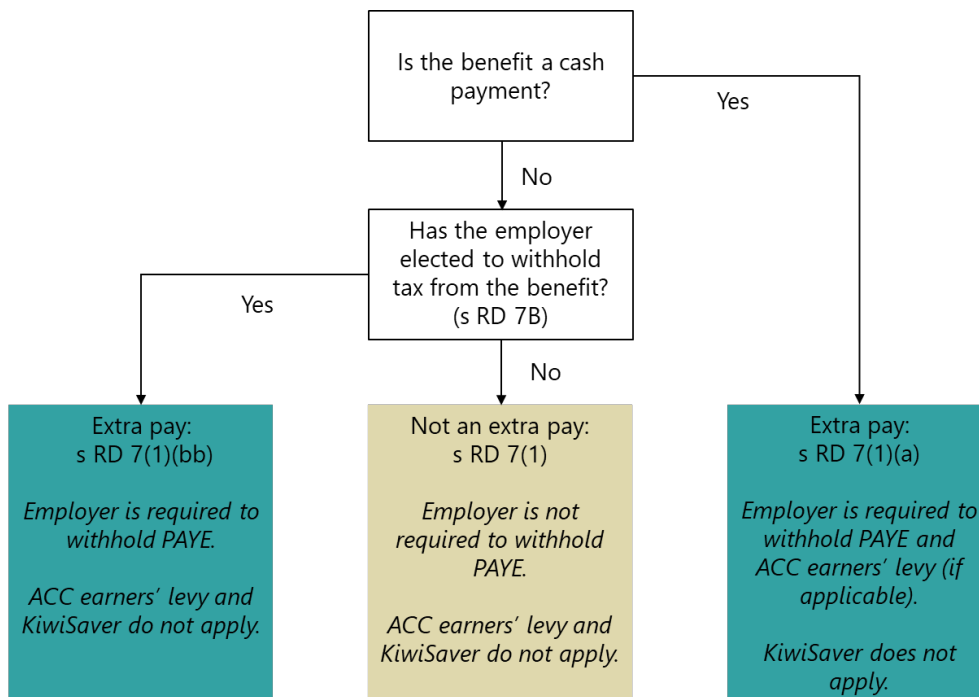
121. A cash-settled ESS benefit is a benefit that an employee receives under s CE 2 of the Income Tax Act and it is treated as an amount of extra pay under s RD 7(1)(a). Therefore, a cash-settled ESS benefit is excluded from the definition of salary or wages for KiwiSaver purposes. As such, an employer is not required to make deductions or employer contributions in relation to a cash-settled ESS benefit.

122. For completeness, an employer is not required to make KiwiSaver deductions or employer contributions in relation to a share-settled benefit where the employer has elected to withhold tax. In this situation the share-settled benefit is treated as an extra pay under s RD 7(1)(bb) and is excluded from the definition of salary or wages for KiwiSaver purposes.
123. In summary, an employer is not required to make KiwiSaver deductions or employer contributions in relation to a cash-settled ESS benefit. This outcome arises because KiwiSaver deductions and contributions are based on an employee’s gross salary or wages and a cash-settled ESS benefit is excluded from the definition of “salary or wages” for the purposes of the KiwiSaver Act.

## Overall summary

124. Figure | Hoahoa 1 summarises an employer’s PAYE and KiwiSaver obligations for both cash- and share-settled ESS benefits.

**Figure | Hoahoa 1: Employee benefits under an ESS (ss CE 1(1)(d) and CE 2)**



## Examples | Taurira

### Example | Taurira 1 – Phantom share scheme

After a successful performance review, Ellen receives a letter from her employer Garments Ltd inviting her to participate in the company's employee share plan. The letter grants her 1,000 Restricted Stock Units (RSUs). The market value of Garments' shares is \$10 on grant date. The RSUs will vest after 3 years. Ellen does not pay anything for the RSUs. Ellen will forfeit the RSUs if she leaves Garments within 3 years of the grant date.

The letter and the share plan rules state the RSUs are virtual shares that conditionally entitle Ellen to receive a cash payout corresponding to the value of a real share on the vesting date. The RSUs do not entitle Ellen to ownership of Garments' shares, voting rights or dividend payments.

Ellen continues to be an employee of Garments and the RSUs vest 3 years after the grant date. The market value of Garments' shares on the vesting date is \$50. Ellen receives a payment of \$50,000 in the month after the RSUs vest.

Although the arrangement mimics an ESS, the fact that the RSUs are virtual, and Ellen receives a cash payout and is not entitled to become a shareholder under the plan, means that the plan is **not an "employee share scheme"** for tax purposes. The arrangement does not have "a purpose or effect of issuing or transferring shares" in a company to an employee.

The payment is a cash bonus or extra pay and is income to Ellen under s CE 1(1)(a). It is an extra pay under s RD 7(1)(a) and a PAYE income payment. Garments Ltd will have the usual PAYE and KiwiSaver obligations.

### Example | Taurira 2 – Incentive scheme involving a combination of cash and shares

On 1 July 2021 Jaya, an employee of Research Ltd, receives an award letter advising that she is eligible to participate in the company's incentive scheme. The award letter states that Jaya will potentially receive cash and shares subject to the terms of the scheme. The rights are provided in relation to Jaya's employment with Research Ltd and she does not pay anything to acquire the rights.

Jaya's maximum incentive under the scheme is \$50,000. She will receive this as 50% cash and 50% shares, to the extent that she meets specific performance goals for the financial year.

In August 2022, Jaya is advised that she has met all of her performance goals and her conditional entitlement has vested in full. In September 2022, Jaya receives \$25,000 cash and 5,000 of Research Ltd's shares valued at a total of \$25,000 (based on Research Ltd's share price in September 2022).

The arrangement is an "employee share scheme". It is connected to Jaya's employment and it has a purpose or effect of transferring shares in Research Ltd to Jaya. At the time the arrangement is entered into, an objective effect of the arrangement is to transfer cash and shares to Jaya, so there is a purpose of transferring shares.

The shares Jaya receives are a benefit under an ESS. The value of the benefit calculated under s CE 2(1) is \$25,000 (ie the market value of the shares on the share scheme taxing date, which is the date she received them in September 2022). The value of the benefit is income to Jaya under s CE 1(1)(d). Research Ltd can choose whether to withhold tax on the value of the benefit under ss RD 7(1)(bb) and RD 7B. No matter whether Research Ltd withholds tax or not, it must report the value of the benefit in its employment income information.

**The cash payment does not give rise to a "benefit" under an ESS** under s CE 2(1). This is because the cash is not paid in relation to a transfer or cancellation of Jaya's rights under the scheme. The cash is paid in satisfaction of the rights granted to Jaya.

The cash payment is still income to Jaya under s CE 1(1)(a) as a bonus or extra pay. The cash payment will be an extra pay under s RD 7(1)(a) and a PAYE income payment. As it is a PAYE income payment, Research Ltd will have the usual PAYE obligations. Research Ltd will also have KiwiSaver obligations (if applicable) because the payment is an extra pay and not a benefit under an ESS.

### Example | Taura 3 – Performance rights with cash or shares at employer's discretion

On 30 March 2020, Billy is granted rights by his employer, Sneakers Ltd, to 1,000 shares in Sneakers Ltd. However, company management reserves the right to grant Billy the cash value of the shares, rather than actual Sneakers Ltd shares.

The rights are provided in relation to Billy's employment with Sneakers Ltd, and Billy does not pay anything for them. Billy will forfeit the rights if he ceases this employment within 3 years of the date of grant.

On 31 March 2023, Billy receives cash in satisfaction of his rights.



The arrangement is an “employee share scheme”. It is connected to Billy’s employment and has a purpose or effect of transferring shares in the company to Billy even though Billy ultimately received cash and not shares. At the time the arrangement is entered into, an objective effect of the arrangement is to transfer either cash or shares to Billy, so there is a purpose of transferring shares.

However, the cash payment does not give rise to a “benefit” under an ESS. This is because the cash is not paid in relation to a transfer or cancellation of Billy’s rights under the scheme. The cash is paid in satisfaction of the rights granted to Billy.

The cash payment is **not a benefit received under an ESS**, but it is still income to Billy under s CE 1(1)(a) as a bonus or extra pay. The cash payment will be an extra pay under s RD 7(1)(a) and a PAYE income payment. As it is a PAYE income payment, Sneakers Ltd will have the usual PAYE obligations. Sneakers Ltd will also have KiwiSaver obligations (if applicable) because the payment is an extra pay and not a benefit under an ESS.

#### **Example | Taura 4 – Option scheme, at employer’s discretion, where employee receives cash**

Rawiri is employed by Gumboots Ltd. On 30 March 2020 Gumboots Ltd grants Rawiri options to buy 1,000 shares in Gumboots Ltd. The exercise price is \$1 per option, which is the market value of the shares on grant date. Company management reserves the right to cancel the options on vesting and pay Rawiri the cash equivalent (ie the market value of the shares on the vest date less the exercise price).

The options are provided in relation to Rawiri’s employment with Gumboots Ltd. Rawiri will forfeit the options if he ceases employment within 3 years of the date of grant.

Rawiri stays employed for 3 years. The market value of the shares at that time is \$5. On the vest date, Gumboots Ltd cancels the options and pays Rawiri the cash equivalent (ie \$4,000).

The arrangement is an “employee share scheme” because it has a purpose or effect of transferring shares in a company to an employee. At the time the arrangement is entered into, an objective effect of the arrangement is to transfer cash or shares to Rawiri, so there is a purpose of transferring shares.

The cash payment gives rise to a “benefit” under the ESS, calculated under s CE 2(1). This outcome arises because the payment is made in relation to the cancellation of Rawiri’s share options.

Therefore, Rawiri has received a benefit under an ESS that is income to him under s CE 1(1)(d). As Rawiri has received cash (and not shares), the payment is a **cash-settled ESS benefit**.

A cash-settled ESS benefit is an extra pay under s CE 7(1)(a) and a PAYE income payment. Gumboots Ltd will have the usual PAYE obligations that apply to an extra pay. Gumboots Ltd does not have any KiwiSaver obligations in relation to a cash-settled ESS benefit.

### **Example | Taura 5 – Option scheme, at employee’s discretion, where employee receives cash**

Marie is employed by Travel Ltd, a publicly listed company. Travel Ltd grants Marie options to buy 1,000 shares in Travel Ltd. The exercise price is \$1 per option, which is the market value of the shares on grant date. The options will vest the following year if the company meets its financial targets and Marie remains employed by Travel Ltd. Marie will have 3 years to exercise the options. Alternatively, she can choose to receive a cash equivalent during the 3-year exercise period. If Marie chooses to take cash, Travel Ltd will cancel the options in return for a cash payment equal to the market value of the shares at the time less the exercise price. It is the company’s preference that employees exercise the options rather than take cash because the objective of the scheme is to incentivise employees through company ownership. The company offers a cash payout alternative for those employees who do not wish to own shares.

The company meets its financial targets, Marie remains employed and the options vest. Two years later, Marie decides to take a cash payout. The market value of the shares at that time is \$10 per share. Marie receives a cash payment of \$9,000.

The arrangement is an “employee share scheme”. It is connected to Marie’s employment and it has a purpose or effect of transferring shares in the company to Marie even though Marie can choose to receive cash instead of shares. At the time the arrangement is entered into, an objective effect of the arrangement is to transfer shares to Marie, so there is a purpose of transferring shares.

The cash payment gives rise to a “benefit” under the ESS, calculated under s CE 2(1). This outcome arises because the payment is made in relation to the cancellation of Marie’s share options.

Therefore, Marie has received a benefit under an ESS that is income to Marie under s CE 1(1)(d). As Marie has received cash (and not shares), the payment is a **cash-settled ESS benefit**.

A cash-settled ESS benefit is an extra pay under s CE 7(1)(a) and a PAYE income payment. Travel Ltd will have the usual PAYE obligations that apply to an extra pay. Travel Ltd does not have any KiwiSaver obligations in relation to a cash-settled ESS benefit.

### Example | Tauria 6 – Sale of company, share-settled benefit

Steve is a key employee of Tech Ltd, a privately owned company. Tech Ltd invites Steve to participate in the company incentive scheme. Steve is granted options to purchase 100,000 shares in Tech Ltd. The exercise price is \$1 per share, which is the fair market value of the shares on grant date. The options will vest in 4 years if Steve is still an employee of Tech Ltd. If Steve leaves the company, any options that have not vested will be forfeited. Steve has 5 years from the vesting date to exercise the options.

The terms of the scheme state that if the company is sold to a third party, vesting will be accelerated and occur on the date of the sale, and Steve will be required to exercise his options and then sell and transfer all of his shares to the purchaser. Tech Ltd will receive the purchase price of the shares, deduct the exercise price and pay the balance to Steve.

Three years after Steve is granted the options, Tech Ltd is sold to an unrelated third party for \$3 per share (which is market value). On the date of the sale, Steve’s options vest, he exercises them, the shares are issued and then sold and transferred to the purchaser. Tech Ltd pays Steve the purchase price less the exercise price.

The scheme is an “employee share scheme”. It is an arrangement with a purpose or effect of issuing or transferring shares in Tech Ltd to Steve and the arrangement is connected to Steve’s employment.

In this situation, the share scheme taxing date is triggered by the issue of the shares to Steve.

The shares issued to Steve are a benefit under an ESS. The value of the benefit calculated under s CE 2(1) is \$200,000 (ie the market value of the shares on the date they are issued to Steve less the exercise price).

The amount of the benefit is income to Steve under s CE 1(1)(d). Tech Ltd can choose whether to withhold tax from the benefit under ss RD 7(1)(bb) and RD 7B. Regardless of whether Tech Ltd chooses to withhold tax:

- Tech Ltd is required to report the value of the benefit in its employment income information on the relevant date and the amount of tax withheld (if any); and
- ACC earners' levy and KiwiSaver do not apply to a share-settled benefit.

### Example | Taura 7 – Sale of company, cash-settled benefit

The facts are the same as in Example | Taura 6 except that, instead of specifying that Tech Ltd issues shares to Steve and then immediately sells them to the purchaser, the terms of the scheme state that if the company is sold to a third party, vesting will be accelerated and the vested options will be cancelled in return for a cash payment equivalent to the sale price of the shares less the exercise price.

Three years after Steve is granted the options, Tech Ltd is sold to an unrelated third party for market value. The vesting of Steve's options is accelerated and the unexercised options are cancelled in return for a cash payment equal to the market value of the shares less the exercise price.

In this situation, the share scheme taxing date is triggered by the cancellation of the options.

The payment gives rise to a benefit under s CE 2(1). The amount of the benefit is the amount of consideration paid to Steve in relation to the cancellation of the share options under the ESS.

The amount of the benefit is income to Steve under s CE 1(1)(d). As Steve received cash (and not shares), the payment is **a cash-settled ESS benefit**.

A cash-settled ESS benefit is an extra pay under s CE 7(1)(a) and a PAYE income payment. Tech Ltd will have the usual PAYE obligations that apply to an extra pay. Tech Ltd does not have any KiwiSaver obligations in relation to a cash-settled ESS benefit.

### Example | Taura 8 – Unwind of ESS, cost for shares, cash payment

Bozco Ltd provides an employee, George, with a loan of \$10,000 to acquire shares in Bozco Ltd for market value. If George leaves Bozco Ltd and is a “bad leaver” (as defined in the terms of the scheme), he must transfer the shares to Bozco Ltd for the lower of cost and market value. If George leaves Bozco Ltd and is a “good leaver” (as defined in the terms of the scheme), he must transfer the shares to Bozco Ltd for market value. In either case, he must repay the loan at the time of transfer.

A “good leaver” has a very narrow meaning under the terms of the scheme, meaning anyone who leaves due to death, serious illness or retirement. A “bad leaver” has a very broad meaning under the terms of the scheme, meaning anyone who is not a good leaver.

George retires 10 years later. As George is a “good leaver”, the shares must be transferred to Bozco Ltd for market value. Market value at the time is \$30,000. Accordingly, George transfers the shares to Bozco Ltd and Bozco Ltd pays George \$20,000 (which is the \$30,000 purchase price for the shares less \$10,000 that is applied in repayment of the loan).

The scheme is an ESS. It is an arrangement with a purpose or effect of issuing or transferring shares in Bozco Ltd to George and the arrangement is connected with his employment.

The consideration George receives for the transfer of the shares under the ESS, less the cost of the shares to George, is a benefit under an ESS. The value of the benefit calculated under s CE 2(1) is \$20,000 (ie the \$30,000 George receives for transfer of the shares on retirement, less the \$10,000 he paid to acquire the shares). The value of the benefit is income to George under s CE 1(1)(d).

As George’s benefit under s CE 2(1) was in cash (rather than shares), the payment is **a cash-settled ESS benefit**.

A cash-settled ESS benefit is an extra pay under s CE 7(1)(a) and a PAYE income payment. Bozco Ltd will have the usual PAYE obligations that apply to an extra pay. Bozco Ltd does not have any KiwiSaver obligations in relation to a cash-settled ESS benefit.

*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  
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## About this document | Mō tēnei tuhinga

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