Inland Revenue
Te Tari Taake

INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

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

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IS 25/04

This interpretation statement considers what an employee share scheme is, including the exclusions to the definition. The statement then explains when the share scheme taxing date arises and when shares are held by or for the benefit of an employee. It also covers the circumstances when the share scheme taxing date may be deferred. Finally, it addresses how benefits are apportioned when some of the employee's entitlement arises when they are non-resident.

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

START DATE | RĀ TĪMATA

Tax Information Bulletin Vol 30, No 5 (June 2018) explains the legislative changes to the employee share scheme regime. At page 55 it states "[t]here is no change to the share scheme taxing date for straight-forward employee share options, which already reflects this principle, in that the employee is not taxed until the option is exercised." To the extent taxpayers can demonstrate they have reasonably relied on this statement of principle and the position set out in this interpretation statement gives rise to a different result, it will apply from the issue date above.

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Introduction | Whakataki

1. The employee share scheme (ESS) tax regime changed in 2018. The objective of the changed rules is to treat ESS benefits neutrally so that, to the extent possible, whether remuneration for labour is paid in cash or shares the tax position does not change for either the employer or the employee.
2. Following the changes to the rules, we have received various questions about how the law applies in certain scenarios. This statement addresses some of those questions by explaining what constitutes an ESS, when the share scheme taxing date (SSTD) arises and how benefits are apportioned. While each case will need to be considered on its on facts, examples at the end of this interpretation statement show how the rules may apply.
3. This interpretation statement does not consider the implications of any anti-avoidance provisions. The outcomes set out may not apply where the general anti-avoidance provision (s BG 1) or the specific ESS anti-avoidance provision (s GB 49B) applies.

What is an employee share scheme?

4. Section CE 7 defines an ESS as follows:

> **CE 7 Meaning of employee share scheme**
>
> **Employee share scheme** means—
>
> (a) an arrangement with a purpose or effect of issuing or transferring shares in a company (**company A**) to a person—
>
> (i) who will be, is, or has been an employee of company A or of another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:
>
> (ii) who will be, is, or has been a shareholder-employee in relation to company A or in relation to another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:
>
> (iii) who is an associate of a person described in subparagraph (i) or (ii) (**person A**), if the arrangement is connected to person A's employment or service; but
>
> (b) does not include an arrangement that—
>
> (i) is an exempt ESS:
>
> (ii) requires market value consideration to be paid by a person described in paragraph (a) for the transfer of shares in the company on the share scheme taxing date:

(iii) requires a person described in paragraph (a) to put shares, acquired by them for market value consideration, at risk, if the arrangement provides no protection against a fall in the value of the shares and none of the consideration for acquiring the shares is provided to the person under an agreement that it is used for acquiring the shares.

5. The requirements of s CE 7(a) are discussed below in [6] to [31] followed by discussion of the exclusions set out in s CE 7(b) in [32] to [46].

Arrangement to issue or transfer shares in a company: s CE 7(a)

6. Broadly, an ESS is:

   - an arrangement with a purpose or effect of issuing or transferring shares in a company
   - to a person who will be, is or has been an employee (or shareholder-employee) of that company or another company in the same group
   - if it is connected to the employee's (or shareholder-employee's) employment or service.

7. An employee and shareholder-employee are persons described in s CE 7(a)(i) and (ii) and are both referred to as the "employee" in this interpretation statement for ease of reference.

8. An ESS also includes providing shares to an associate of an employee (being a person described in s CE 7(a)(iii)), if the arrangement is in connection with the employee's employment or service.

9. Accordingly, the person who might receive shares under an ESS could be the employee or an associate. This interpretation statement refers to such a person as the "ESS beneficiary" (as also defined in s CE 7C). Regardless of whether the employee or an associate receives the shares or related rights, it is the employee that derives any employment income from the ESS as set out in s CE 1(1)(d) and s CE 2 (see at [47] and [48]). This is because s CE 2(1) provides that a person who is described in s CE 7(a)(i) or (ii) (being the employee or the shareholder-employee) receives the benefit calculated under s CE 2 and therefore the income under s CE 1(1)(d).

10. 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. Terms of the arrangement may be included in ancillary documents, such as shareholders' agreements.

11. Example | Tauira 1 shows when an arrangement involving an employee's shares might not have a purpose or effect of transferring shares to an employee.

12. Three key aspects are discussed in further detail below. These are:
   - What is a "share" in a "company" for income tax purposes?
   - Who is an "employee" for income tax purposes?
   - When is an arrangement "connected to" the person's employment or service?

What is a "share" in a "company" for income tax purposes?

13. An ESS involves the issue or transfer of "shares in a company".

14. For the purposes of the Income Tax Act (Act), a "company" is defined in s YA 1 to mean a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere. The definition has further inclusions and exclusions for income tax purposes – for example, a unit trust is a company for income tax purposes.

15. A "share" is defined broadly in s YA 1 as follows:

> **share—**
>
> (a) includes any interest in the capital of a company:
>
> (b) includes a debenture to which section FA 2 (Recharacterisation of certain debentures) applies:
>
> (bb) includes a stapled debt security to which section FA 2B(2) (Stapled debt securities) applies:
>
> (c) includes a unit in a unit trust:
>
> (d) includes an investor's interest in a group investment fund if—
>
> (i) the fund is not a designated group investment fund; and
>
> (ii) the interest does not result from an investment from a designated source; and
>
> (iii) the investor's interest does not result from an investment made in the fund on or before 22 June 1983, including an amount treated as invested at that date as pre-1983 investments under section HR 3(8) (Definitions for section HR 2: group investment funds):
>
> (e) does not include a withdrawable share in a building society, except in the definitions of investment society dividend and withdrawable share:

> (f) [Repealed]
>
> (g) is further defined in section CW 26F (Meaning of share) for the purposes of section CW 26C (Meaning of exempt ESS)

16. Often, a share will be issued under the relevant jurisdiction's companies' legislation, such as the Companies Act 1993 (CA 1993) in New Zealand. However, the definition in s YA 1 has various inclusions and exclusions for income tax purposes.

17. Paragraph (a) of the definition is often applied, being "any interest in the capital of a company". This phrase reflects the common law meaning of a "share" rather than the meaning under the CA 1993.

18. In *IRC v Woolf* [1962] 1 Ch 35, the English Court of Appeal was considering whether debenture holders were "members" of a company, which was defined with reference to whether they had "an interest in the capital or profits or income" of the company. Upjohn LJ said at 46 and 47:

> The share or interest of a member in the capital of a company has no precise legal signification. In the context it may refer to the share or interest of the member in the issued share capital, or it may refer to his ultimate right to receive a dividend in liquidation after all creditors have been discharged…
>
> …
>
> … Further, the debenture-holder has no interest in the capital of the company. If "capital" refers to the share capital, that is obviously so. If it refers to the surplus in a winding-up, the debenture-holder will have been paid off before the surplus can be ascertained.

19. Similarly, Donovan LJ said at 45:

> The word "capital", where it occurs as part of the definition of "member", may mean issued share capital or the net capital, being the difference between assets and liabilities, or it may mean both. …

20. In *Woolf* then, a reference to "capital" of a company was taken to mean share capital and/or net capital (assets less liabilities) and included the right to receive distributions on a winding up, after all creditors have been paid.

21. Accordingly, "any interest in the capital of a company" for the purposes of the definition of a "share" in s YA 1 may refer to the person's interest in issued share capital, a right to a share in the surplus assets on a wind up, and may include rights to other distributions. An interest in a company's capital is an interest in the performance of the company that is of an equity nature (rather than a debt or contractual right to receive payments).

22. The definition of a "share" for income tax purposes also specifically includes many instruments that are not shares under the CA 1993 such as profit related debentures, stapled debt securities, units in a unit trust, and interests in a group investment fund. These are all types of instruments that exhibit general features of equity.

23. This interpretation statement proceeds on the basis that the arrangement under consideration is with a purpose or effect of issuing or transferring "shares" in a "company", as those terms are defined for income tax purposes.

24. For completeness, para (g) in the definition of "share" contains a specific definition relevant to "exempt ESS" and limited to s CW 26C. This specific (narrower) definition of a share is relevant only for determining whether there is an exempt ESS for the specific purposes of s CW 26C. This is because an exempt ESS must be widely offered to almost all employees and provide the same rights to all employees. Exempt ESS are discussed briefly at [33] and [34] and are not the focus of this interpretation statement.

Who is an "employee" for income tax purposes?

25. For the purposes of the Act, an "employee" is defined to include a person who receives or is entitled to receive a "PAYE income payment". This includes a payment of "salary or wages", "extra pay" or a "schedular payment". A "schedular payment" is a payment of a class set out in sch 4 of the Act, that in turn lists payments made to a wide variety of workers including, for example, certain directors.

26. Accordingly, the term "employee" for income tax purposes (and therefore the ESS rules) includes persons that are employees under common law (ie under a contract of service) and, if they receive schedular payments, also persons that may be independent contractors under common law (ie under a contract for service). For more information on what constitutes an "employee" for tax purposes see IG 16/01: **Determining employment status for tax purposes (employee or independent contractor?**).

27. A common example of a person that might be an independent contractor at common law but an employee for tax purposes because they receive schedular payments, and therefore are subject to the ESS rules, is a company director. For more discussion of when fees paid to directors are schedular payments, see IS 17/06: **Application of schedular payment rules to directors' fees** and IS 19/01: **Income tax – application of schedular payment rules to non-resident directors' fees**.

When is an arrangement "connected to" the person's employment or service?

28. To constitute an ESS, the arrangement with a purpose or effect of issuing or transferring shares to an ESS beneficiary must be connected to the employee's employment or service. The Commissioner considers that this means the employment

or service must be a substantial reason for the arrangement. This is discussed in further detail in the context of fringe benefit tax and whether a benefit is provided in connection with a person's employment in the commentary to BR Pub 09/02: **Federal Insurance Contributions (FICA) – Fringe Benefit Tax (FBT) Liability** at pages 10 and 11.

29. Where the arrangement is provided for in the person's employment contract, or pursuant to an employment policy or established practice of the employer, the Commissioner considers it is likely that the employment relationship will be the substantial reason for the provision of shares. This is because the right to receive the shares is part of the terms under which the employee agreed to provide their services to the employer.

30. Where there are reasons apart from, or not sufficiently connected to, the employment relationship that explain why the arrangement was entered into, the arrangement may not be in connection with the person's employment. The courts have on occasion considered the employment relationship was no more than part of the background facts or a mere historical connection. In these situations, the employment connection may not be sufficient enough to result in employment income (see for example the case law discussed in the commentary to BR Pub 06/05: **Assessability of payments under the Employment Relations Act for humiliation, loss of dignity, and injury to feelings** at pages 10 to 12).

31. Example | Tauira 2 and Example | Tauira 3 show when a transfer of shares to an employee might not be in connection with employment.

Arrangements excluded from being an employee share scheme: s CE 7(b)

32. Three exclusions are set out in s CE 7(b) for arrangements that would otherwise be an ESS. These are discussed from [33]. Example | Tauira 4 to Example | Tauira 8 show how some of the exclusions set out in s CE 7(b) may, or may not, apply.

First exclusion – exempt employee share schemes

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

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

Second exclusion – market value paid on share scheme taxing date

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

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

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

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

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

38. The definitions deal with shares that are quoted on a recognised exchange and those that are not. For the former, the market value will usually be the quoted value on the exchange at the relevant time but s CE 7CB(b) extends the range of values that are acceptable. For the latter group of shares, the market value will be the value that a willing purchaser would pay at arm's length for the shares with certain qualifications as to the method that is used to determine the amount.

39. CS 24/01 **Determining the "market value" of shares that an employee receives under an employee share scheme** provides guidance on what methods are acceptable to us for determining the value of shares received under an ESS. It deals with listed and unlisted shares.

40. This second exclusion applies if market value consideration is paid for the transfer of the shares on the SSTD. The SSTD is considered in more detail from [47] and is broadly when shares are held by the ESS beneficiary or for their benefit and there are no conditions or protections under the ESS that defer the date under s CE 7B(1)(a).

Third exclusion – market value paid on acquisition and shares at risk

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

42. The third exclusion applies if:

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

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

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

45. A contrasting scenario is where the ESS beneficiary is required to sell the shares back to the employer for an amount equal to the cost of the shares if the employee resigns

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

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

The benefit and the share scheme taxing date

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

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

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

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

> **CE 7B Meaning of share scheme taxing date**
>
> *Meaning*
>
> (1) **Share scheme taxing date** means, in relation to shares or related rights under and employee share scheme, the earlier of the following dates:

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

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

- Under s CE 7B(1)(a), the first date when the shares are held by or for the benefit of an ESS beneficiary (referred to as "beneficial ownership") and, after which, there are no conditions or protections under the ESS that defer the date under subparas (i) to (iii).
- Under s CE 7B(1)(b), the date when the shares or related rights of an ESS beneficiary are cancelled or are transferred to a person who is not associated.

51. Example | Tauira 9 shows when the SSTD might be triggered by each of s CE 7B(1)(a) and (b).

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

- Example 14 in *Tax Information Bulletin* Vol 30, No 5 (June 2018): 59 shows s CE 7(b)(2)(a) could apply, for example, where the employee is required to sell

their shares back to the employer for market value consideration if they leave the company after they have vested.

- Example 15 in *Tax Information Bulletin* Vol 30, No 5 (June 2018): 59 shows s CE 7B(2)(c) could apply where an employee has a right to sell shares back to the company for a nominal amount because such a right is unlikely to be utilised.

53. The remainder of this interpretation statement considers when the SSTD arises under s CE 7B(1)(a); in other words, when the SSTD is triggered by share ownership rather than cancellation or disposal of the benefit. In general, there are two matters to consider:

- Are the shares "held by or for the benefit of" an ESS beneficiary so there is the "beneficial ownership" referred to in s CE 7B(1)(a)?
- Does the arrangement provide any conditions or protections referred to in s CE 7B(1)(a)(i) to (iii) that result in the SSTD being deferred to a later time?

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

54. It is first necessary to establish "the first date when the shares are held by or for the benefit of an ESS beneficiary". These words are abbreviated to "beneficial ownership" in s CE 7B(1)(a). This can be satisfied by either:

- the ESS beneficiary holding the shares; **or**
- another person holding the shares for the benefit of the ESS beneficiary.

55. Example | Tauira 9 to Example | Tauira 11 show how the s CE 7B(1)(a) requirement that shares are held by or for the benefit of an ESS beneficiary impacts the SSTD.

When shares are "held" by a person

56. The Act does not define the phrase "held by". The most relevant definition of "hold" as a verb in the *Oxford English Dictionary* is:

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

57. Based on these definitions, shares are "held" by a person when the person becomes the owner of the shares.

58. What constitutes a "share" for income tax purposes is set out in [13] to [24] above. While it is a broad definition, often a share will be issued under the relevant jurisdiction's companies' legislation (such as the CA 1993 in New Zealand).

59. The CA 1993 contains provisions relevant to determining when a person holds a share in a company registered in New Zealand. For example, s 89 provides:

> **89 Share register as evidence of legal title**
>
> (1) Subject to section 91, the entry of the name of a person in the share register as holder of a share is prima facie evidence that legal title to the share vests in that person.
>
> …

60. The words "held" and "hold" are commonly used to mean legal ownership of shares according to the company's register of members. A leading case in this area is the High Court of Australia's decision in *Dalgety Downs Pastoral Company Pty Ltd v FCT* (1952) 86 CLR 335. The court in *Dalgety* looked at s 80(5) of the Australian legislation that governed the carrying forward of company losses. The section required that shares carrying at least 25% of the voting power in the company be "beneficially held" by the same persons during the relevant period. The issue was whether continuity of shareholding had been maintained when a shareholder transferred his shares as security for a loan. The court concluded the shares were held by the person whose name appeared in the company's share register. The court stated at 341–342:

> …. Dixon J so held in *Avon Downs Pty Ltd v FCT* (1949) 78 CLR 353, basing his conclusion upon the view that **in the terminology of company law shares are said to be "held" by the person who is registered as a shareholder** in respect thereof, and that s 80(5), being concerned with voting power, should be treated as using that terminology. We share this view. Indeed **it is not too much to say that the verb "hold" and its variants, when used in relation to shares in companies, normally refers to the legal ownership of the shares according to the register of members.** The Companies Acts of the United Kingdom and of several States of the Commonwealth have uniformly used the word in this sense, and common usage has followed their example. [Emphasis added]

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

62. If the "share" for income tax purposes is not a share issued under the relevant jurisdiction's companies' legislation (for example, if it is some other interest in the performance of the company that is of an equity nature), it will need to be determined who holds or is the legal owner of that interest.

63. In summary, in the context of an ESS and the SSTD, shares are "held by" a person when the person has legal ownership of those shares.

64. For completeness, s YB 21 contains an exception to this rule. It states:

YB 21 Transparency of nominees

Treatment of nominee

(1) In this Act, unless the context otherwise requires, if a person holds something or does something as a nominee for another person, the other person holds or does that thing and the nominee is ignored.

Who is a nominee?

(2) A person holds or does something as a nominee for another person if the person acts on the other person's behalf. However, a trustee is a nominee only if the trustee is a bare trustee.

…

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

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

67. What it means for a person to be nominee for another in respect of shares is considered in detail from [86] in **IS 12/01: Income tax – timing of share transfers for the purposes of the continuity provisions**. Perhaps of relevance, IS 12/01 summarises when a vendor of shares may "hold" shares as "nominee" for the purchaser, including when the share transfer agreement has been settled. In those circumstances the vendor is the bare trustee for the purchaser of shares under an agreement that has been settled but the purchaser is not the registered holder of the shares. In such a case the purchaser may go on to be registered, or may never be registered.

68. It is unlikely s YB 21 will have a significant impact on outcomes in the context of s CE 7B(1)(a) because of the requirement that "shares are held by **or** for the benefit of" an ESS beneficiary. In other words, the definition of SSTD already extends to a person legally holding shares for someone else.

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

69. When shares are "held by" a person is discussed at [56] to [68]. For the purposes of s CE 7B(1)(a), the shares must be held either by the ESS beneficiary **or** by someone else

for the benefit of an ESS beneficiary. Where shares are held by a person for the benefit of the ESS beneficiary, the ESS beneficiary will not be the legal owner of the shares or named on the company's share register.

70. "For the benefit of" has been said to mean "in trust for". In *Gillespie v City of Glasgow Bank* (1879) 4 App Cas 632 (HL) at 642 Lord Hatherley said:

> I cannot perceive a difference between the words "for behoof of" and "**in trust for**". I hold the expression "for behoof of" to mean exactly the same as if the words used had been "on behalf of" or "**for the benefit of**", or any of those other words, of which many might be suggested, which indicate that although to the bank you are the absolute owner of the shares, yet as regards a third person, with whom you have entered into an arrangement you are not that owner.' [Emphasis added]

71. This passage from *Gillespie v City of Glasgow Bank* was cited with approval in *Case D27* (1980) 4 NZTC 60,621.

72. To hold shares for the benefit of someone means you are not beneficially the owner of the shares. The person for whose benefit you hold the shares is the beneficial owner. In *Gillespie v City of Glasgow Bank* Lord Hatherley said at 641 and 642:

> … Whether you say you hold "for behoof of" some one, or you hold "on behalf of" someone, or you hold "in trust for" some one, there is no particular magic in the choice of words; all those words indicate that you are not beneficially the owner. You in effect tell the creditors of the concern, As between you and me, I am the holder of the stock, but as between me and a third person with whom you have nothing to do, I am the holder of it for that person's benefit.

73. Accordingly, shares will generally be held for the benefit of another person where that other person has the right to the economic benefits, or fruits, of the shares. This is referred to as "beneficial ownership". Whether shares are held for the benefit of an ESS beneficiary will depend on the terms of the ESS.

74. In some instances, a trust may be established to facilitate the ESS and hold shares for the benefit of ESS beneficiaries during a period of restrictions on the shares under the ESS. In such a case, if the employee has the required beneficial ownership the question will be whether any of the deferral provisions apply. Example | Tauira 9 illustrates this.

75. This can be contrasted with the situation of a group establishing a trust (ESS trust) to acquire and hold shares for the general purposes of the group share plans depending on the market and funding available at any given time. In such a case, the employer can sometimes choose how to satisfy its obligations to provide shares – perhaps by issuing shares, purchasing shares on market or via its ESS trust. If the shares in the ESS trust can be applied at the employer's discretion it is unlikely the shares will be held for the benefit of an ESS beneficiary. Example | Tauira 11 illustrates this.

76. A similar situation can arise when a company holds shares in itself (commonly referred to as treasury stock). Some companies may prefer to hold treasury stock to meet obligations under an ESS rather than having to sporadically issue new shares or establish a trust to maintain a pool of shares. In such a case, the question is whether the company holds any of its treasury stock for the benefit of an ESS beneficiary. Similar to the situation of a trustee described above, if the company merely holds a pool of shares to use as and when needed and is not subject to any terms or restrictions regarding its use and transfer of those shares, it is unlikely the company is holding shares for the benefit of an ESS beneficiary.

Determining when shares are transferred

77. We understand that often the process to transfer shares to an ESS beneficiary begins when an option is exercised or share rights vest under the scheme – for example shares are issued by the company, transferred from a trust or purchased on market. However, the actual transfer is often not able to be completed on the same date due to processes required to issue and transfer shares. Commentators have suggested it can be difficult to determine the exact date when those shares are held by the ESS beneficiary, or by someone for the benefit of the ESS beneficiary. We understand this is particularly an issue for global schemes where software calculates the benefit on the exercise date or vesting date (as applicable), and where payroll teams in New Zealand may not have access to any information other than the exercise date or vesting date.

78. The Commissioner will accept that the best evidence of when the shares are held by or for the benefit of the ESS beneficiary could be the vesting date or exercise date under the ESS (as applicable) for the purposes of determining the SSTD under s CE 7B(1)(a) where the following requirements are met:

- the shares are expected to be held by or for the benefit of the ESS beneficiary within 10 working days after the exercise date or vesting date under the ESS; and
- the employer is unable to determine the exact date by taking reasonable steps.

79. The above is shown in Example | Tauira 12. The Commissioner expects this practice would be applied consistently by the employer for the ESS.

Do any conditions or protections defer the taxing date?

80. If an ESS beneficiary holds the shares or has "beneficial ownership" for the purposes of s CE 7B(1)(a) (as described from [54] to [79]), it is necessary to consider whether any provisions that may defer the SSTD set out in s CE 7B(1)(a) apply. This section discusses these deferral provisions. Example | Tauira 6 to Example | Tauira 9 illustrate how some of the deferral provisions set out in s CE 7B(1)(a) may, or may not, apply.

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

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

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

Example 1 – Simple vesting period

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

Example 2 – Vesting subject to misconduct

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

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

84. Section CE 7B(1)(a) will only defer the SSTD where there is a material risk. If there is no material risk, the SSTD will arise when the shares are held by or for the benefit of the ESS beneficiary. Example | Tauira 13 shows what happens if the SSTD arises when there is not a material risk of a change in beneficial ownership, and forfeiture does in fact result.

Benefit accruing in relation to a fall in share value

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

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

Material risk of a change in the share terms

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

88. For example, this provision might apply if the ESS provides for restricted shares to be reclassified as ordinary shares and have the same rights as ordinary shares when a specified event occurs. Where this material risk exists, s CE 7B(1)(c) will defer the SSTD until the specified event occurs.

Apportionment

89. As set out at [47] and [48], the amount of an employee's benefit is calculated under s CE 2(1). It is essentially the market value of the shares or related rights owned by an ESS beneficiary on the SSTD (or the amount of consideration paid to an ESS beneficiary for a transfer or cancellation of those shares or rights) less any consideration provided by an ESS beneficiary.

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

91. Section CE 2(5) states:

Apportionment

(5) For the person's benefit under subsection (1), the portion of that benefit calculated using the formula is treated as non-residents' foreign-sourced income—

benefit before reduction × offshore period ÷ earning period.

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

Definition of items in formula

(6) In the formula in subsection (5),—

(a) **benefit before reduction** is the amount of the benefit under subsection (1):

(b) **offshore period** is the number of days in the item **earning period** on which—

(i) the person is not resident in New Zealand; and

(ii) any services the person performs for the relevant employer give rise to an amount of income that is a foreign-sourced amount:

(c) **earning period** is the period ending with the vesting of shares or relevant rights in the employee share scheme beneficiary and starting with the earlier of—

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

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

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

94. As set out in IS 19/01: **Income tax – application of schedular payment rules to non-resident directors' fees**, the Commissioner considers that directors' fees a New Zealand company pays to a non-resident individual will, in most cases, have a New Zealand source regardless of whether the directorship services are performed in New Zealand or from overseas. Accordingly, it may be a non-resident director of a New Zealand company will rarely be able to apportion any of the benefit to non-residents' foreign-sourced income.

95. The earning period is intended to reflect the period over which the employee is earning the shares or related rights. This is not necessarily the same as the SSTD when

the employee takes beneficial ownership of the shares, which may occur at a later stage. The purpose of apportioning the benefit over the earning period, rather than to the SSTD, is to ensure the employment income resulting from the ESS benefit is taxable in New Zealand to the extent it was earned while the employee was a New Zealand resident and/or deriving employment income sourced in New Zealand. Example | Tauira 14 illustrates how the apportionment may operate when an employee moves to New Zealand during the earning period.

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

97. In the context of an ESS, a common requirement is that an employee must work for the company for a specified period. Until the employee has worked for that period, they will not have a fixed right of future enjoyment of those shares or related rights as those shares or rights may not come to fruition. The provisions of the ESS may allow employees to retain their benefit if they leave earlier in certain circumstances, such as due to retirement, serious illness or death. Such leavers are often referred to as "good leavers" in ESS documentation, and the scope of what is a "good leaver" is determined by the ESS documentation. Where an employee retains their benefit under the terms of an ESS if they leave as a good leaver, the Commissioner considers that the employee will have a present fixed right of future enjoyment of the shares or related rights when they become a good leaver, as they have done what is necessary to earn the shares or related rights that will come to fruition. This is the case whether it is explicitly referred to as accelerating the benefit or not. Accordingly, in such circumstances, the shares or related rights will have vested for the purposes of determining the end of the earning period in s CE 2(5) and (6).

98. As noted at [95], the end of the earning period under s CE 2(6) may not always coincide with the SSTD under s CE 7B. For example, where an employee receives an option to acquire shares that is exercisable following a specified period of employment, the earning period will end at the conclusion of the specified period of employment. This occurs when the ESS beneficiary has done what is necessary to earn the right to acquire shares, ie the option is exercisable. However, the SSTD will not arise until the option is exercised and the shares are held by or for the benefit of the ESS beneficiary, or the option is cancelled or transferred to a non-associate if that occurs earlier. Example | Tauira 15 and Example | Tauira 16 illustrate when the earning

period under s CE 2(6) could end and when the SSTD under s CE 7B could arise in some circumstances involving a good leaver.

Examples | Tauira

99. While each case will need to be considered on its on facts, these examples show how the rules discussed in this interpretation statement may apply.

Example | Tauira 1: Founder putting shares at risk to attract capital investment

Company was established by Carl, Jordyn and Lacey in 2015. All three were unrelated and non-associated individuals at the time. They had ideas for a software product that would make life easier. Carl was the biggest driver of the project, had the most expertise in the area, and was made CEO.

On incorporation, the initial shareholdings were as follows:

- Carl – 50%
- Jordyn – 25%
- Lacey – 25%

Market value was paid for the shares and they are not subject to any conditions or restrictions.

By 2022, the product was mostly ready but significant investment was required to market the product and set up appropriate distribution channels. A third party investor was found that was interested in the product and willing to inject funds into Company in subscription for shares. The investor considered that Carl's involvement in Company was crucial to success of the product, at least in its early stages of distribution. Accordingly, as part of the deal, Carl was required to agree to forfeit half his shares to the investor for nil consideration should he leave Company within 5 years of the capital being injected.

The arrangement that Carl may forfeit half his shareholding is not part of any arrangement with a purpose or effect of transferring shares to an employee for the purposes of s CE 7(a) and therefore the arrangement would not constitute an ESS. The fact that Carl ends up putting his shares originally acquired in 2015 at risk in 2022 does not bring those shares into the ESS rules.

Example | Tauira 2: Review of initial share allocations on incorporation of company

Company was established by Chris, Joanna and Grant in 2010. All three were unrelated and non-associated individuals at the time.

On incorporation:

- Chris contributed some incomplete designs and know-how for an initial shareholding of 46.5%
- Joanna contributed some marketing contracts she had arranged to target and research potentially interested markets for an initial shareholding of 48.5%
- Grant contributed some start-up cash for an initial shareholding of 5%

Chris is the CEO and a shareholder employee of Company. Chris has received an appropriate amount of remuneration in exchange for his services to Company since incorporation.

An independent review has been undertaken to consider whether the original share allocations were fair to Chris when Company was first incorporated. This review does not take into account Chris's activities as CEO (for which he has been appropriately remunerated). The review has concluded that the designs and know-how contributed by Chris, while incomplete, were at least as valuable as the marketing contracts provided by Joanna. Following the review, Joanna decides to transfer 1% of her shareholding to Chris for nil consideration so they have equal shares in Company.

It is unlikely that a transfer of 1% of the shares in Company from Joanna to Chris for nil consideration would be a transfer of shares "in connection with employment" for the purposes of s CE 7(a) and therefore the arrangement would not constitute an ESS.

Example | Tauira 3: Succession following retirement

Company was established by Susan, Jeremy and Joseph in 2012. Jeremy is Susan's only child. Joseph is unrelated to Susan and Jeremy.

On incorporation, the initial shareholdings were as follows:

- Susan – 34%
- Jeremy – 33%
- Joseph – 33%

Susan, Jeremy and Joseph are the CEO, CFO and COO respectively. Each has received an appropriate amount of remuneration in exchange for their services to Company since incorporation.

Susan is retiring and wants to pass her shares to Jeremy for nil consideration as she does not need the income from the shares in her retirement. Jeremy will become the new CEO and will receive an appropriate amount of remuneration for these services going forward. Company is to outsource the CFO role to a virtual CFO provider.

It is unlikely that a transfer of Susan's shares to Jeremy for nil consideration would be a transfer of shares "in connection with employment" for the purposes of s CE 7(a) and therefore the arrangement would not constitute an ESS.

Example | Tauira 4: Shares acquired on incorporation of a company

Casey, Joelle and Mary get together and incorporate a company with a view to developing some technology-related intellectual property (IP). They are each issued 20 shares on incorporation of the company and employed by the company. When the shares are issued they are worth virtually nothing and a nominal subscription price of $1 per share is paid by each shareholder-employee. The shareholders' agreement states that to ensure they commit to developing the IP over 3 years, if they leave within 3 years they forfeit their shares.

Is the arrangement an ESS under s CE 7?

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

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

Section CE 7(b)(iii) will be satisfied as market value was paid for the shares, not using money provided to the shareholder-employees for that purpose, and the shareholder-employees have then chosen to put the shares at risk. This means the scheme is not an ESS and the ESS rules do not apply to the scheme.

Variation of facts regarding incorporation

In some circumstances shares in a company on incorporation will not be worth virtually nothing and may have a market value.

Instead, say Casey, Joelle and Mary have been working on developing their IP for some time and have reached a point where it is looking like it could be profitable with the right investment to put it into production and market it.

At this point, Casey, Joelle and Mary think it might be time to formalise matters and incorporate a company. They each contribute their respective IP and related assets to the company in subscription for shares. The shareholders' agreement states that to

ensure each commit to further developing the business over the next 3 years, if they leave within 3 years they forfeit their shares to the remaining founders.

In this case, the shares in the company will have a value and not be worth virtually nothing due to the assets contributed to the business. However, s CE 7(b)(iii) will still be satisfied as each of the founders paid market value for the shares by contributing the IP and related assets.

Further variation of the facts

Say Casey, Joelle and Mary also employ Grant for his technical expertise to get the IP ready for production. Given the business is cash poor, they offer Grant shares on incorporation for a nominal consideration of $1 so he can benefit from any uplift in the value of the company. The shareholders' agreement states that if Grant leaves within 3 years, the company will repurchase his shares for the nominal consideration of $1.

The arrangement has a purpose or effect of transferring shares in a company to a person in connection with their employment and is therefore an ESS under s CE 7(a). An exclusion to the definition of ESS in s CE 7(b) will not apply for Grant's shareholding. This is because the shares on incorporation do have a market value and Grant has only paid a nominal consideration. Accordingly, the ESS rules will apply to Grant's shares that he received on incorporation.

Example | Tauira 5: Employees of target company reinvesting in acquirer

Acquirer Co is looking to purchase all the shares in Target Co. The employees of Target Co hold 20% of its shares.

As part of the acquisition and to continue incentivising employees to act in the best interests of Target Co, Acquirer Co provides the employees the option to reinvest a portion of their sale proceeds into shares in Acquirer Co (at market value). This provides employees the opportunity to benefit from any uplift in value following the takeover. However, if they choose to do this, they are locked in for a 3-year period and if they leave during that time they will forfeit their shares for the lower amount of cost or market value. The employee can choose whether to reinvest or not; the employee is not required to use their sale proceeds to reinvest in Acquirer Co.

Is the arrangement an ESS under s CE 7?

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

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

Section CE 7(b)(iii) will be satisfied as:

- market value was paid by the employee for the shares in Acquirer Co;
- the employee is required to put the shares in Acquirer Co at risk;
- the arrangement provides the employee with no protection against a fall in value of the shares in Acquirer Co; and
- the employee was not provided consideration for acquiring the shares in Acquirer Co under an agreement that it is used to acquire the shares. This is because the employee has a choice whether to reinvest and use their sale proceeds to purchase shares in Acquirer Co.

This means the scheme is not an ESS and the ESS rules do not apply to the scheme.

Example | Tauira 6: Shares acquired with limited recourse loan

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

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

Is the arrangement an ESS under s CE 7?

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

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

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

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

When does the SSTD arise under s CE 7B?

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

Example | Tauira 7: Shares acquired with full recourse loan and potential transfer at market value

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

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

Is the arrangement an ESS under s CE 7?

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

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

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

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

When does the SSTD arise under s CE 7B?

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

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

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

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

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

Example | Tauira 8: Shares acquired with full recourse loan and potential transfer at lower of cost and market value

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

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

Before then, the employee bears the risk of loss but has no chance of gain. If the shares fall to $5,000 and the employee leaves Employer Co within 3 years, Employer Co

will buy the shares back for $5,000 and the employee will lose $5,000 of their $10,000 investment. If the employee leaves Employer Co within 3 years and the shares are worth $20,000, then Employer Co will buy them back for $10,000 and the employee will be denied the upside.

Is the arrangement an ESS under s CE 7?

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

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

Section CE 7(b)(ii) does not apply. While the employee pays market value consideration, they do not do so on the SSTD. The SSTD does not arise until the 3-year period ends (as set out under the next heading of this example).

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

When does the SSTD arise under s CE 7B?

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

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

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

Accordingly, the first date on which the employee holds the shares and none of the deferral provisions applies is at the end of the 3-year period. The employee can enjoy any gain in the value of shares from this date given that they have now met the scheme's criteria. Before this date, the employee has exposure to any fall in value of the shares but cannot receive any upside.

Example | Tauira 9: Employee leaves employment early or continues employment

Employer Co grants 100 shares to each of its senior employees Sarah, John and Arnie, to incentivise their performance. Under the terms of the arrangement, an employee forfeits the shares for nil consideration if they leave the employ of Employer Co within 5 years, unless they are a "good leaver". For the purposes of the plan, a good leaver is defined narrowly as someone who leaves due to retirement, disability or death.

A trustee holds the shares for the 5-year period to ensure forfeiture can be implemented and the shares returned to Employer Co if necessary. Dividends are paid to the employee over this period as they arise (unless they have forfeited their interest). At the end of the 5 years, if the employee has not forfeited their entitlement they will be transferred the shares for no further cost.

After 1 year, Sarah resigns to take up a better offer in Australia. After 3 years, Arnie retires (as a good leaver under the terms of the ESS). John stays with Employer Co for many years.

When does the SSTD arise under s CE 7B?

The SSTD will not arise at the time the employee is granted the shares. This is because, while the shares are held by the trustee for the benefit of the employee, a material risk exists that they will forfeit their beneficial interest if they leave this employment within 5 years (other than as a good leaver). This means the SSTD is deferred under s CE 7B(1)(a)(i).

When Sarah resigns she forfeits her beneficial interest for nil consideration. Accordingly, the SSTD will arise when she leaves Employer Co under s CE 7B(1)(b). As Sarah received no consideration for the forfeiture of her rights, and paid no consideration for the grant of the rights, Sarah will not have any benefit under the formula in s CE 2.

When Arnie retires he does not forfeit his benefit, as he is a good leaver under the terms of the ESS, and he will be transferred the shares at the end of the 5-year period. At the time of Arnie's retirement there is no longer a material risk that he will forfeit the shares. As the shares are held by the trustee for Arnie's benefit, the SSTD will therefore arise on Arnie's retirement under s CE 7B(1)(a). Arnie's benefit under s CE 2 will be the market value of the shares at the time of Arnie's retirement. As Arnie did not pay anything for the shares there is no deduction from this value.

When John reaches his 5 years of employment he will be transferred the shares. At this point there is no longer a material risk that he will forfeit the shares. Accordingly, the SSTD will arise at that point under s CE 7B(1)(a). John's benefit under s CE 2 will be

the market value of the shares when John reaches his 5 years of employment. As John did not pay anything for the shares there is no deduction from this value.

Example | Tauira 10: Delay in issue of new shares following exercise of option

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

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

When does the SSTD arise under s CE 7B?

On 1 June 2022 the employee has completed a year of employment and therefore has the right to exercise the option.

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

When the new shares are issued to the employee on 15 September 2022 the SSTD will arise under s CE 7B(1)(a). As the employer is aware of the date the shares are issued the position discussed above in [78] does not apply.

Example | Tauira 11: Delay in issue or delivery of shares and use of a trust

Under an ESS, an employee of Employer Co is entitled to receive 1,000 shares if they remain with Employer Co for 3 years. Employer Co can satisfy this obligation by issuing shares, purchasing shares on market or via a trust established for the purposes of facilitating its ESS. The employee satisfies this requirement on 10 August 2022.

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

Employer Co decides to issue 1,000 new shares to the employee under the terms of the ESS. It takes a few days for the appropriate resolutions to be documented and the shares are issued to the employee on 15 August 2022.

The SSTD will arise on 15 August 2022 under s CE 7B(1)(a). This is because that is the first date when the shares are held by or for the benefit of the employee. Before

15 August 2022, the shares did not exist and therefore could not be held by any person. As the employer is aware of the date the shares are issued the position discussed above in [78] does not apply.

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

Instead, say there are sufficient shares in Employer Co's ESS trust to satisfy the employee's entitlement. Accordingly, on 10 August 2022 Employer Co directs the trustee, who in turn directs the share registry provider, to transfer 1,000 shares out of its pool of shares to the employee. The shares are put in the employee's name as soon as possible by the share registry provider.

Until 10 August 2022 the shares have not been beneficially held for the employee. Until the 10 August 2022 direction, the trustee has held the general pool of shares for the purposes of the ESS and is required to act on Employer Co's instructions regarding whether to buy, sell or transfer any of its shares. Any dividends paid on the general pool of shares are used for the purposes of the trust.

The shares will be held by or for the benefit of the employee on 10 August 2022 (and not before). On and from 10 August 2022 (and not before) Employer Co and the trustee cannot act in respect of those shares inconsistently with transferring them to the employee. When the employee satisfies 3 years of employment on 10 August 2022, there is also nothing to defer the SSTD under s CE 7B(1)(a). Accordingly, the SSTD will arise on 10 August 2022.

When does the SSTD arise if Employer Co needs time to calculate the employee's entitlement?

Say instead the employee is entitled to receive up to 1,000 shares if they remain with Employer Co for 3 years, subject to the company meeting certain financial conditions. The same trust arrangements apply as set out above.

Employer Co takes 3 weeks after 10 August 2022 to determine whether the financial conditions have been met and whether the employee is entitled to the full entitlement of 1,000 shares. It is determined the employee is entitled to 800 shares. On 31 August 2024 Employer Co directs the trustee, who in turn directs the share registry provider, to transfer 800 shares out of its pool of shares to the employee. The shares are put in the employee's name as soon as possible by the share registry provider.

The shares will be held by or for the benefit of the employee on 31 August 2022 (and not before). On and from that date (and not before) Employer Co and the trustee cannot act in respect of those shares inconsistently with them transferring to the employee. Accordingly, the SSTD will arise on 31 August 2022.

Example | Tauira 12: Incomplete information from foreign parent company

Under an ESS, an employee of NZ Employer Co is entitled to receive 1,000 shares in US Parent Co if they remain employed by the group for 3 years. The share plan states that US Parent Co can satisfy this obligation by issuing shares, purchasing shares on market or via a trust established for the purposes of facilitating its ESS. The employee becomes entitled to the shares on 10 August 2022 having been employed by the group for 3 years.

When does the SSTD arise?

NZ Employer Co's payroll team asks US Parent Co when the shares will be transferred to the employee so that it can determine when shares are held by or for the benefit of the employee and when the SSTD arises.

US Parent Co advises NZ Employer Co's payroll team the shares will be transferred to the employee within 1 week of the employee becoming entitled. Despite asking for clarification, NZ Employer Co receives no further details.

As the shares are expected to be transferred to the employee within 10 working days of the employee satisfying the share plan requirements, and Employer Co is unable to determine the exact date having taken reasonable steps to determine the exact date, the Commissioner will accept the best evidence of when the shares are held by or for the benefit of the employee as being the date the employee satisfies the share plan requirements. Accordingly, the employer treats 10 August 2022 as the SSTD as discussed above in [78].

Alternative facts – limitations of payroll software

Alternatively, the group's global payroll software reports benefits as arising on the date an employee becomes entitled. NZ Employer Co's payroll team asks US Parent Co when the shares will be transferred to the employee so that it can confirm whether 10 August 2022 is the correct SSTD.

US Parent Co does not reply in a timely fashion. However, NZ Employer Co knows from previous experience that shares are always transferred to employees within 1 week of the employee becoming entitled.

As the shares are expected to be transferred to the employee within 10 working days of the employee satisfying the share plan requirements, and Employer Co is unable to determine the exact date by taking reasonable steps, the Commissioner will accept the best evidence of when the shares are held by or for the benefit of the employee in this

case is the date the employee satisfies the share plan requirements. Accordingly, the employer treats 10 August 2022 as the SSTD as discussed above in [78].

Example | Tauira 13: Acquisition subject to misconduct

Employer Co offers its senior employees the chance to buy into the company at a 50% discount. Employee takes up this offer and acquires 100 shares worth $10,000 for a price of $5,000.

Under the terms of the arrangement, employee forfeits the shares for an amount equal to the lower of cost and market value if they leave the employ of Employer Co because they are dismissed for serious misconduct within 3 years of the acquisition.

When does the SSTD arise under s CE 7B?

The SSTD will arise at the time the employee acquires the shares under s CE 7B(1)(a). As set out in example 2 in s CE 7B, the risk that the employee will be dismissed for serious misconduct is not material. Accordingly, while employee may be required to transfer the shares if they are dismissed for serious misconduct within 3 years, this is not a material risk and therefore the SSTD is not deferred under s CE 7B(1)(a)(i).

Accordingly, employee's benefit will be $5,000 (the market value of the shares on the SSTD of $10,000 less the cost to the employee of $5,000) in the year they acquire the shares.

What if employee is dismissed for serious misconduct?

Say employee is dismissed for serious misconduct 2 years after acquiring the shares. The market value of the shares at the time is $12,000. Accordingly, employee forfeits the shares for their cost of $5,000.

This does not alter the conclusions that the SSTD has passed and a benefit of $5,000 arose in the year of acquisition. That outcome is not reversed under the ESS rules.

The tax implications of the forfeiture of the shares will need to be evaluated based on the circumstances of the employee and the forfeiture at the time, outside of the ESS rules. For example, the following may need to be considered – whether the shares are:

- Held on revenue account. If so, further income may arise in respect of the forfeiture. The employee should then be entitled to a deduction for the cost of the revenue account property, including the amount of the employee's benefit arising from receiving the shares (see s CE 2(4)).
- Repurchased by the company. If so, the dividend and treasury stock rules may need to be considered.

- In a foreign company. If so, the international tax rules may need to be considered.

Example | Tauira 14: Employee moves to New Zealand during earning period

Employer Co, a New Zealand resident company, has an employee who is not a tax resident in New Zealand and performs their employment duties in Germany such that their services give rise to a foreign-sourced amount of income. The employee purchases 1,000 shares in Employer Co under an ESS by paying an acquisition price of $20,000, which is equal to 50% of their market value at the time. If the employee leaves Employer Co before the end of the 3 years, they forfeit their interest and the shares are transferred back to Employer Co for an amount equal to their cost.

Under the terms of the ESS, a trustee holds the shares for a period of 3 years to ensure forfeiture can be implemented and the shares returned to Employer Co if necessary. Dividends are paid to the employee over this period as they arise unless they have forfeited their interest. At the end of the 3 years, if the employee is still with Employer Co, they will be transferred the shares for no further cost.

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

When is the SSTD under s CE 7B?

The SSTD under s CE 7B(1)(a) is at the end of the 3-year period when the employee is entitled to be transferred the shares. This is when the shares are held by or for the benefit of the employee and, after this point, none of the matters set out in subparas (i) to (iii) could apply to defer the date. Prior to this time, there is a material risk the shares will be transferred back to Employer Co if the employee leaves Employer Co. This means the SSTD will not arise under s CE 7B(1)(a)(i) until the 3 years of employment is satisfied.

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

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

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

For the purposes of the calculation, the "earning period" under s CE 2(6)(c) is 3 years (being 1,095 days). The "offshore period" under s CE 2(6)(b) is the 2 years (being 730

days) the employee is not resident in New Zealand and is performing services in Germany such that their services give rise to a foreign-sourced amount of income. Once the person moves to New Zealand and performs services in New Zealand, the offshore period will end.

This means 2/3rds (being 730/1,095 days) of the benefit amount is treated as non-residents' foreign-sourced income and is not assessable to the employee in New Zealand.

Example | Tauira 15: Good leaver retaining benefit and being issued new shares in accordance with ordinary vesting schedule

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

The employee works for 2 years in Germany and then retires to New Zealand. As a "good leaver", they keep their entitlement and are issued new shares at the end of 3 years.

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

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

If the shares were already in existence and held for the benefit of the employee when they retire as a good leaver, the SSTD could arise earlier (as illustrated in Example | Tauira 16).

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

However, for the purposes of determining the amount of the benefit that is non-residents' foreign-sourced income for the employee under s CE 2(5), the earning period defined in s CE 2(6)(c) is 2 years (being 730 days) as the employee's retirement is when their right to future possession of the shares "vests". This is because, upon retiring and being a good leaver under the terms of the ESS, the employee has a present fixed right of future enjoyment of the shares.

The offshore period (when the employee is non-resident and performing services offshore) under s CE 2(6)(b) is also 2 years (being 730 days). This means the entire benefit is treated as non-residents' foreign-sourced income and is not assessable to the employee in New Zealand.

Example | Tauira 16: Good leaver retaining benefit and being transferred shares from an ESS trust in accordance with ordinary vesting schedule

Employer Co, a New Zealand resident company, has an employee who is not a tax resident in New Zealand and performs their employment duties in Germany such that their services give rise to a foreign-sourced amount of income. The employee purchases 1,000 shares in Employer Co by paying an acquisition price equal to 50% of market value at the time. If the employee leaves Employer Co before the end of the 3 years other than as a "good leaver" the shares are transferred back to Employer Co for an amount equal to their cost. A "good leaver" is defined in the ESS as being where they leave due to retirement, disability or death.

Under the terms of the ESS, a trustee holds the shares for a period of 3 years to ensure forfeiture can be implemented and the shares returned to Employer Co if necessary. Dividends are paid to the employee over this period as they arise (unless they have forfeited their interest). At the end of the 3 years, if the employee is still with Employer Co, or has left as a "good leaver" they will be transferred the shares for no further cost.

The employee works for 2 years in Germany and then retires to New Zealand. As they are a "good leaver" they keep their entitlement, and the trustee transfers the 1,000 shares to the employee at the end of 3 years.

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

The SSTD under s CE 7B(1)(a) is when the employee retires as a good leaver in this case. This is because the trustee holds the shares for the employee's benefit and, after this point, none of the matters set out in subparas (i) to (iii) could apply to defer the

date. In other words, this is when the market value of the shares must be determined for the purposes of calculating the employee's benefit income under s CE 2(1).

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

The amount of the benefit that is non-residents' foreign-sourced income for the employee under s CE 2(5) is the same as in Example | Tauira 15. Briefly, the earning period defined in s CE 2(6)(c) is 2 years (being 730 days) because the employee's retirement is when their right to future possession of shares "vests". The offshore period (when the employee is non-resident and performing services offshore) under s CE 2(6)(b) is also 2 years (being 730 days). This means the entire benefit is treated as non-residents' foreign-sourced income and is not assessable to the employee in New Zealand.

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About this document | Mō tēnei tuhinga

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