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Deputy Commissioner for Policy & Strategy
Inland Revenue Department
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Dear Struan

TAXATION OF EMPLOYEE SHARE SCHEMES

The Angel Association NZ has contributed to work to prepare KPMG's submission on the Taxation of Employee Share Schemes. KPMG is an AANZ sponsor.

2 AANZ's members include ten active angel investment networks and angel funds operating nationally. Between them they represent over 750 individual angel investors. These groups are playing a leading role in regularly catalysing over $50 million of annual investment into internationally focused technology startups. These angel investors have established a track record, for over a decade now, as crucial cornerstone investors in the NZ early-stage company, capital market.

3 We write to provide our own specific emphasis to the critical importance of effective employee share ownership tax policy. ESOPs have a very real and direct impact on the success of startup and growth companies. Getting the policy settings wrong will seriously constrain the ability of these ventures to succeed and maximize their economic impact. Founders and their teams, and then investors, all get involved because they want to grow highly successful companies. Despite the risks, this is the unifying objective across all of these ventures from their outset.

4 A recent survey of angel-backed companies carried out by the New Zealand Venture Investment Fund illustrated the fundamental role ESOP plays in this context. Over 90% of the 50 respondents had ESOP arrangements in place. In cash strapped startups ESOPs are a particularly powerful way of securing and incentivizing employees and directors that a venture may not otherwise be able to afford or attract. ESOPs are also an effective way of aligning the interests of key employees with founders and investors to drive for growth and success.

5 Clearly we have no issue taxing income generated from ESOP schemes. But the emphasis here must be on the existence of "income". The reality is that about 20-30% of startups will fail within their first 2-4 years. Of the remaining companies, only 5-10% are likely to experience some form of liquidity event (enabling shareholders to realise value from their shareholding) within their first 5-8 years. With the vast majority of startups there is extremely limited scope for employees to actually capture monetary value from their shareholdings, especially in their first few years. In these circumstances, what they have by owning options (or exercised options) is not really 'income" in any shape or form.

6 In most cases where ESOPs are created in startup companies (unless complicated structures are adopted), and where options are exercised, tax must be paid on income that only exists "on paper" or hypothetically. In the startup context there is also very little ongoing liquidity for shareholdings in these ventures. It is very uncommon for parcels of shares to be able to be traded in any way while a startup is in its early years. There is usually no way of capturing or securing any monetary value as a shareholder (or option holder) until there is a "realization of value" event such as a trade sale to a strategic acquirer. While some of these companies will also go on to succeed in their own right (that is not be acquired) and generate profits and dividends, it is likely to be a significant number of years after they are originally founded before they reach this position.

7 We are aware of some 20 different “ESOP-type” structures for what should ideally be a simple concept. We therefore suspect one of the reasons for the issues paper may be that the IRD would like to address this myriad of structures. In our context complicated regimes are often put in place to ameliorate the impact of the company or the individual being taxed on non-existent or paper-based income. We share KPMG’s concern that the proposals put forward by the IRD in the issues paper have the very real prospect of making the landscape even more complex, introducing further unnecessary inefficiencies, cost and confusion.

8 We are also concerned about inconsistencies potentially being created in the government’s economic development policy. The recent financial markets reforms make it easier to issue shares to employees but there is a very real risk that the proposals in your issues paper will undermine the impact of this reform. Taxing options to buy shares in a startup at their granting, rather than when they actually vest, will discourage the use of ESOPs.

9 The IRD may also want to take a broader look at the role of tax incentives to drive economic development and the creation of internationally orientated high growth companies. Startup companies have no cash to create alignment and a sense of ownership as they chart their high-risk courses. Achieving alignment and incentivisation through equity ownership is one lever at their disposal and it is being used increasingly to this end in the European and North American startup markets.

10 Though ESOPs are also highly valuable for attracting directors, “founder and employee startup equity” is by far the most important use of ESOPs. There are three key components of founder and employee startup equity. ‘Founder equity’ is created before there is any external cash in the business (i.e. typically beyond capital provided by sources such as founders, friends and family), ‘sweat equity’ is created when early employees trade ‘cash for services’ for ‘equity for services’ and ‘growth or value creation equity’ is created where a second category of very early employees (which often overlap with the first) are brought on to exponentially drive up the value of a venture. There is a strong argument for more favorable tax treatment, such as deferral, for each of these categories of equity in the early years of a startup venture’s life.

11 Even current tax settings, where share options are taxed on exercise and not on granting, lead to results that arguably do not properly take account of these different categories of “startup equity”, nor of the high levels of illiquidity of startup shareholdings. While “founder equity” strictly speaking will generally be held on capital account with no tax payable on any income received in relation to their shareholding in the future, someone who comes into a venture in the early stages and receives “growth equity” or “value creation equity” in the form of share options is in a very different situation.

12 They/the company can exercise their options now and they/the company will pay income tax at that point. But as noted above they are really being taxed at that point on non-existent or paper-based income only. Or alternatively the employee can exercise the options at a later stage, perhaps when there is some form of liquidity event pending. But at that point they will potentially need to pay income tax on the (hopefully) substantial difference between the option exercise price per share and the actual current value per share. While that person’s impact on the success of the venture may have been as great as (or even greater in some cases) than that of a “founder”, their share of the economic success of the venture will be significantly less at that point. Some of the potential power that comes from true alignment of interests through an ESOP is being lost even under current tax settings.

13 We would of course welcome the opportunity to talk through any of the issues we have raised above in more detail with you or your team.

Yours sincerely,

Marcel van den Assum
Chairman