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Taxation of employee share schemes
c/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
P O Box 2198
Wellington 6140
Attention: Casey Plunket

23 June 2016

Dear Sir

KPMG Submission — Taxation of employee share schemes

KPMG is pleased to make a submission on the officials' issues paper "Taxation of employee share schemes" ("the Issues Paper").

1 General comments

Employee share schemes ("ESS") are a useful way for businesses to motivate, reward and retain key employees. They encourage employee engagement in their performance and, therefore, ultimately the success of the business.

The Issues Paper provides a welcome touch point for discussing how ESS benefits should be taxed, particularly given Inland Revenue's recent Revenue Alert on ESS. That Revenue Alert has created significant uncertainty around the acceptable features of ESS generally.

In preparing our submission we have consulted with a range of stakeholders, including ESS design specialists, public and private companies, and start-ups currently offering ESS in the market.

A key theme of the feedback we have received is that any amendments to the taxation of ESS should result in certainty of outcomes for both employers and their employees and that the rules must be clear and simple to apply.

We acknowledge that the variety of ESS and employers and employees who are parties to ESS make it difficult to design a fair, simple and effective set of tax rules. However, this means that the principles must be well established and demonstrated. If they are not, any trade-offs made are not transparent and the rules are therefore less readily accepted.

Further, given the principled position that an employer will be entitled to a deduction for employee benefits provided, there is at most a 5% differential in tax raised. In our view, this helps with the view that the system should tax employment income while acknowledging the capital elements of an ESS.

2 Summary of our submission

The Issues Paper categorises ESS as follows:

- **Unconditional ESS** –shares and options that are provided to employees free from any conditions. Officials consider that these awards are remuneration for past work. It is not proposed that the taxation point for the award of unconditional ESS be amended as part of this consultation process.

  We broadly agree that the income in respect of such share awards is earned at the time the shares are received.

- **Conditional ESS** – shares are provided to employees, however they carry a risk of forfeiture based on employment and/or financial performance conditions not being met. Officials consider that these awards are a reward for future work and therefore taxation should occur at the point in the future when all substantial employment and performance conditions are fulfilled.

  We do not agree that conditional share awards are purely remuneration for future services by an employee. In our view, conditional ESS generally contain two components:

  (a) compensation for future employment; and

  (b) investment returns, i.e. dividends and capital gains and losses.

  In order for the tax treatment of conditional ESS to be equitable, the taxing point and mechanism for such share schemes needs to reflect both of these components.

  Any changes to the taxing point of conditional share awards also needs to work for companies where the majority of shares are employee owned and the existence of conditions on shares are a matter of commercial necessity. That is, the tax rules cannot exist in isolation to these commercial considerations.

  Our detailed submissions focus on appropriately identifying and taxing the employment compensation component only, under the ESS rules. Our suggested approach is to follow the UK's tax rules for unapproved restricted securities schemes. That is, the recognition of the investment component as compared to the employment related component of a share award could be achieved through determination of the market value of a share award at each point in time that a substantial condition lapses.

We also comment on the application of the proposed “substantial conditions” test for determining the taxing point.

- **Option-like arrangements** – shares are provided to employees with a range of conditions attached, including price-related conditions to mitigate downside risk. The concern is that these shares are generally acquired by employees for market value, with no tax liability as a result. As with conditional share awards, Officials consider that these are reward for future performance and the proposal is to change the taxing point to when all substantial employment and price-related conditions relating to the shares are fulfilled. This would tax the movement in the market value of the share from the initial share grant until the point in time that substantial conditions no longer apply to the shares.

  Consistent with our recommended approach to conditional share awards, we consider that shares issued under an option-like arrangement may have elements of both employee benefits and investment returns. Only the former should be taxed under the ESS tax rules.

The Issues Paper also seeks submissions on the following matters:

- **Deductibility of ESS benefits** – it is proposed that employers should be allowed a deduction equal to the taxable benefit provided to an employee under an ESS. We strongly support this proposal. This is important to ensure the neutrality of tax treatment between cash and in-kind remuneration.
- **Widely offered share purchase schemes** – it is proposed that the current concessionary tax regime be repealed. We consider instead that the widely offered share purchase scheme rules should be modernised, simplified and broadened to encourage greater use by employers.
- **Start-up companies** – in recognition of the valuation and liquidity issues for employee shares issued by start-up companies, it is proposed that the taxing point be deferred until listing or trade sale of the company. Feedback from the start-up sector is that a key concern with the viability and attractiveness of ESS is the inability to align the taxing point with liquidity events so that employees (or their employers) are able to fund the tax payable. Therefore, we consider the availability of an appropriate deferral mechanism would be of significant value and align with Government’s Business Growth Agenda. However, we are concerned that the proposed deferral mechanism will also tax investment returns and will apply an interest charge. We believe these features are likely to make the proposal unattractive to employers and employees in the start-up sector.
- **Transitional iss**ues - our preference is for a simple rule which allows shares to be granted under existing schemes, under the existing tax rules, for a period. There should be no subsequent application of the new tax rules if the shares are awarded prior to a specific date. That date should be at least 18 months after the enactment of any new rules, to allow new ESSs to be developed and to allow the effect of the new rules on existing schemes to be determined.

- **Administration, record keeping and reporting** – The Issues Paper outlines proposals for additional information to be provided by employers, supporting the PAYE reporting obligations on ESS that will be imposed with effect from 1 April 2017. While we understand the desire for greater real-time information in relation to ESS benefits, this needs to be balanced against the greater compliance burden for employers. Inland Revenue's Business Transformation changes to PAYE should support greater real-time access to ESS information over time. However, this will be a long term process.

The Issues Paper seeks to demonstrate the equality of taxing at different points and analyses various schemes to determine their "economic equivalence" so that their taxation is appropriate. We have concerns with that analysis. We note that in our view:

- Taxing an option at issue or on exercise is not the same and does not show that no capital gains arise.
- Ignoring the tax payable on bonuses which allow repayment of loans obscures what is happening from a tax perspective.
- Treating shares and an employer related loan as a single employment package to justify the proposals is not consistently applied. For example, the logical consequence of this conclusion is that dividends payable would be re-characterised as employment remuneration and the employment loan would be ignored for FBT purposes.

At least in these respects, the case made for the proposed regime is less than convincing.

Finally, we note there are a substantial number of consequential issues. These are not dealt with in the Issues Paper. We consider that leaving these issues for the Bill submission process will not result in good quality policy or legislation. A second round of consultation is required.

Our detailed submissions on the Issues Paper are contained in an Appendix to this letter.

3 Further information

If you would like to discuss our submission please contact us – John Cantin, on 04 816 4518, and Rebecca Armour, on 09 367 5926 and we would be happy cover any points raised in greater detail.

Yours sincerely

JH Cantin

RME Armour

John Cantin
Partner

Rebecca Armour
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Appendix 1. Detailed submissions and comments

1. Matching taxing point for unconditional share and option awards

Issues Paper Submission point: "*We are interested to hear from readers whether they agree that the current tax treatment of unconditional employee share schemes (including employee share options) is appropriate and does not require reform."*

We agree that awards of unconditional shares should be taxed at the date of the award.

In respect of the award of unconditional options, it is proposed that the taxing point also remain unchanged from the existing position which is the date of exercise of that option, rather than its issue.

We submit that the timing of the taxation of options, in the ESS context, needs to be considered to ensure that it is consistent with the tax neutrality approach outlined in the Issues Paper, and in particular the position that ESS benefits are taxed at the time the benefit is received.

There is precedence for recognising the grant of an option as the taxing point (and taxable benefit) in principle. In *Abbott v Philbin* [1961] AC 352 the House of Lords held that the charge to tax for the employee arose in the year the option was acquired and not in a subsequent year when the option was exercised. The Court recognised that the benefit received was the option itself and the fact that the share subsequently increased in value was not a taxable emolument. (We understand from the 1967 McCaw Committee report that there were technical issues (the option was not convertible to cash on issue) which meant that this approach was not applied. Instead, the exercise date was chosen as the taxing point.)[1]

Deferral of the taxing point of the option until the date of exercise has the effect of bringing into ordinary income, any growth in the value of the underlying share. (See the analysis at section 8 of this submission). However, this consideration needs to be balanced with the need to ensure that the timing of the tax obligation does not discourage use of ESS by triggering a liability to tax where there is no possibility of funding that obligation due to the illiquidity of the investment at that time.

The overwhelming response from our discussions with stakeholders was concern that changes to the tax treatment could have an adverse impact on the attractiveness of ESS, for both employees and employers, if a tax obligation is brought forward without the associated liquidity to fund it.

[1] Taxation In New Zealand: Report of the Taxation Review Committee, Chapter 43, paragraph 644, page 257

Accordingly, we consider that the approach proposed in the Issues Paper for unconditional options is appropriate as the recognition of the taxable benefit will be deferred until the date of exercise, when there is more likely to be liquidity to fund the tax obligation. This is a derogation from the neutrality principle as the income is not taxed when derived (on issue). However, it is consistent with taxing employment income when there is cash (see para 2.19 of the Issues Paper).

As this is a derogation, it would be consistent with the theme of tax neutrality to offer employees and employers the opportunity to elect to bring forward the taxing point to the date of grant of the option. We understand that this type of election is available in a number of other jurisdictions including the United States and United Kingdom.

KPMG submission

- The in principle taxing point for an award of unconditional share options should occur at the date of grant; however
- It should be possible for employers and employees to elect to recognise the taxing point as the date of exercise of the option consistent with the current rules.

2. Establishing the border between income from employment and investment returns

Issues Paper Submission point: "*We are interested to hear from readers whether they agree that the current treatment of conditional employee share schemes and option like arrangements is at odds with the neutral framework outlined in Chapter 2."*

The Issues Paper establishes tax neutrality as one of the core principles for consideration of the appropriate assessment of tax on employee share schemes. At 2.19, with reference to the taxation of an employee's benefit, it is stated that "*it is also important that the timing and amount of the income is determined consistently with the timing and amount of other forms of remuneration, most obviously cash*".

Officials' concern with the existing tax treatment of conditional shares is illustrated at example 2 on page 9 of the Issues Paper by reference to a contingent cash bonus which is taxed at the date of receipt rather than the date of offer. The example states that it would be inappropriate for a contingent share award to be taxed on the offer date as opposed to the award date in similar circumstances.

However, this incorrectly equates the value of the shares at the time they are available free of any employment conditions and the value of the cash bonus. The key difference here is that, at the time of offer, the value of the cash bonus at the time of award will generally be known. Therefore, the employee will know their future employment compensation.

The same cannot be said of the grant of employee shares. To the affected employee, for all intents and purposes, the value of employment compensation will be the market value of the shares at the offer date. This is what the employee must be prepared to accept. Any change in value or other return on the shares will not be known ex ante, so cannot be factored into the employees' decision making.

United Kingdom approach to conditional ESS

We consider that the United Kingdom's approach to the taxation of shares under its restricted securities regime may offer a useful framework for ensuring that there is recognition of the employment remuneration and investment return aspects of a conditional share award.

The use of share schemes to incentivise employees is widespread in the UK, with a variety of both HMRC approved and unapproved schemes being available.

We consider that the UK's unapproved restricted securities schemes are analogous to the conditional share awards and option like awards outlined in the Issues Paper. The underlying principle of this regime in the UK is that the liability for tax arises at each point in time that a chargeable event occurs.

As a starting point, restricted share awards which have a risk of forfeiture linked to continuing employment typically (with that risk ceasing to apply within a 5 year time frame) have a charge to tax which is deferred until that risk of forfeiture lapses. It is however possible for employees and employers to make a joint election to bring the charge to tax forward to the date of the award.

Any other relevant condition applying to the award of shares is recognised as impacting upon the market value of the award at the grant date. As conditions lapse, a charge to income tax will arise. The effect of this staggered approach to the tax liability is that there is recognition of growth in value which is as a result of an individual's employment related activities which is subject to income tax, and growth in the value of the employee's investment in the shares, which is a capital gain (the investment return).

In the table below we have extended Example 7 from Chapter 6 of the Issues Paper to illustrate the potential impact of a staggered recognition of the taxable benefit where a taxing event occurs upon the lapse of a condition operating on a share.

In this example we have assumed that the condition results in a 20% discount to market value on the share at Period 1. As 80% of the benefit is taxed at Period 1, when the conditions lapse at Period 2, the amount which remains to be taxed is 20% of the market value of the benefit at that date.

	Period 1	Period 2	High price (shares worth $1000) or low price (shares worth $0)
Tax on share purchase			
Before tax benefit	$100	$670	High price
		0	Low price
Tax paid	$33	$0	High price
		$0	Low price
After-tax value of benefit	$67	**$670**	High price
		$0	Low price
Tax on share option			
Before tax benefit	$100	$1000	High price
		$0	Low price
Tax paid	0	$330	High price
		$0	Low price
After-tax value of benefit	$100	**$670**	High price
		$0	Low price
Tax on available benefit			
Before tax benefit (ignoring conditions)	$100	$1000	High price
		$0	Low price
Market value of tax benefit.	$80	**$200**	High price
		$0	Low price
Tax paid	26.4	**$66**	High price
		$0	Low price
After-tax value of benefit	53.6	**$907.6**	High price
		$0	Low price

Other considerations

If the approach proposed in the Issues Paper is adopted and there is no recognition of share ownership until such time as the conditions cease to apply, then there will be some unintended consequences which arise as a result.

In particular, under the existing regime, employers are able to offer interest-free loans to employees to facilitate the acquisition of shares in the business without imposition of FBT. The Issues Paper does not contemplate a change to this type of arrangement.

Where the upfront acquisition of the shares is ignored for income tax purposes, and the time of acquisition is deferred to a later date, when certain employment or price protection conditions no longer operate on the share, this would create uncertainty as to whether a non-interest bearing loan is offered for the purposes of acquisition of shares in the employer.

Further, in such cases, if no beneficial entitlement to the shares is recognised for tax purposes, any dividends received in the interim would also potentially be regarded as remuneration from employment as opposed to investment returns. Given the proposal to allow a deduction to employers for ESS costs, for the purposes of consistency, it may therefore also be appropriate to allow a deduction to employers for dividends paid on those shares.

KPMG submission

- Liability for income tax, under the ESS rules, for conditional shares awards should only arise to the extent that value is being conferred by the employment relationship and not as a result of the underlying increase in value attributable to external market circumstances.
- Our suggested approach is to follow the UK's tax rules for unapproved restricted securities schemes. That is, recognition of the investment component as compared to the employment related component of a share award could be achieved through determination of the market value of a share award at each point in time that a substantial condition lapses.

3. Deferral of taxation based on removal of "substantial conditions"

Issues Paper Submission point: "*We are interested to hear from readers whether they agree with the "substantial conditions" approach to taxing employee share scheme benefits."*

The Issues Paper proposes that the taxing point for share awards which are provided with certain conditions stipulated, including employment conditions and economic risk protection, should be deferred until such time as no substantial conditions apply.

We consider that not all conditions are substantial, a point which is recognised in 5.22 of the Issues Paper. Therefore, if the proposal proceeds, there will need to be clear guidance on when the substantial conditions "test" will be met. A rule which delays the taxing point where substantial conditions apply to the shares will need to be carefully drafted to ensure that the taxing point can be easily identified. In the absence of clear indicators, we consider that there is a high likelihood of disputes arising between employers, employees and Inland Revenue on the timing of income recognition. In particular, we do not believe that an approach analogous to determining a person's Permanent Place of Abode (PPOA), for tax residence purposes, would be suitable for determining whether a share award is free of substantial conditions, as this will create too much uncertainty.

Further, we understand that Officials are concerned about tax-free returns which may arise to participants of certain share schemes where there is no economic risk borne by those participants. This may arise because of the operation of limited recourse loans, the ability to put shares back to the employer or some other condition which limits the "downside risk" for employees. In addition, where share awards are subject to continuing employment conditions or performance hurdles which essentially prevent an employee from enjoying the growth in value of the underlying share award, there will be limited economic exposure for an employee.

We consider that Officials' concerns regarding the use of downside risk protection mechanisms could be priced into the market value of ESS share awards at the date of grant. This would involve amending the operation of current section CE 3 of the Income Tax Act 2007.

For ease of application, guidance should be provided by the Commissioner on her expectations of the impact standard conditions could have upon the market valuation of share awards.

KPMG submissions

- Substantial conditions which have the effect of delaying the recognition of a taxable share benefit should be clearly stated in legislation. Otherwise there is a substantial risk that uncertainties will remain and the proposals will not meet their objective.
- Downside risk protection, such as a limited or non-recourse loan or put and call arrangement, is a valuable benefit which potentially puts the employee in a better position than a third party investor. That risk limitation should be taken into account at the time of the share award when determining the taxable value of the benefit provided.
- Where employees bear the economic risk of the shares (both upside benefit and downside loss), there should be no deferral of the ESS taxing point, irrespective of whether any other conditions continue to apply to the shares awarded.

Use of conditions as deferral mechanism

As noted above, the ability to defer the recognition of a taxable benefit until such time as a share is liquid would be a key feature of the design and implementation of ESS for many employers.

We consider that the proposed tax treatment of conditional share awards could result in ESS being designed specifically with conditions that enable a deferral of income until such time as a trade sale or IPO is possible.

Where the share drops in value, this may result in the deferred tax liability being less than would have been the case if the share had been taxed at the acquisition date.

KPMG submission

Officials should note that conditions may be built into ESS to specifically defer the taxing point (to align with a liquidity event). That ESS will be designed to meet any new requirements should be acknowledged by Officials and the final policy should be sufficiently clear to enable the parliamentary contemplation test to be applied simply and easily to confirm the acceptability of future ESS.

Wholly or substantially employee owned companies

There may be valid commercial reasons for the imposition of substantial conditions or restrictions when awarding shares to employees, in particular where the award shares are in a company which is wholly or substantially owned by employees.

Share awards in such companies will be vital for succession planning purposes and frequently will include restrictions on disposal, access to information about the company and/or the share value, and other limitations consistent with the commercial requirements of the business.

KPMG submission

Where non-convertible shares are issued to employees with no specified "sunset" date for removal of conditions/restrictions, then the taxing point should be at the date of award and not delayed.

4. Deferral of taxation for start-ups

Issues Paper Submission point: "*We are interested to hear from readers whether this flexibility in the choice of scheme structure is likely to be sufficient to resolve the liquidity and valuation issues for start-up companies, or whether there is a need for legislative solutions to be explored."*

In our discussions with start-up companies, the incidence of tax liabilities without associated access to funds to pay the tax is a deterrent to the use and attractiveness of ESS. We note this will also be an issue under the proposed changes to the tax treatment of share awards under conditional and option-like ESS arrangements, if the share grant is free of substantial conditions prior to a liquidity event, such as listing or sale of the shares.

We therefore support the availability of a deferral mechanism. Our concerns with the proposed statutory deferral for start-ups in the Issues Paper are as follows:

- The taxable benefit would be the difference between the sale price of the shares (at the time of listing or trade sale) less any amount the employee paid to acquire the shares. This assumes that the share grant will be free of substantial conditions only at the time of sale. In the circumstances, where the award of shares is free of substantial conditions earlier, but there is no liquidity option for the employee, the proposed deferral mechanism will over-tax. It should be made clear that the normal rules for conditional ESS apply to determine the quantum of the taxable benefit.
- The proposed application of use of money interest on the deferred tax liability will make the option unattractive, particularly if the potential over-taxation feature above is not addressed.
- It is not clear why any deferral option should be limited to non-dividend paying shares. The time value of money analysis, excludes the tax payable by the employee on the dividends, separately (i.e. as an investment return).

The Government's Business Growth Agenda is focussed on building a more competitive and productive economy with innovation and investment identified as core priorities. To support this objective, we consider that it is important that start-up companies are able to attract and incentivise talent in an appropriate way having regard to the cost constraints associated with establishment of new businesses.

ESS tax rules that recognise the cash-poor nature of start-ups and the importance of "sweat equity" to these firms are vital.

KPMG submissions

- Deferral of tax obligations under the ESS rules is important for illiquid shares.
- Employees of start-ups should not be penalised for deferral by imposition of significant additional costs (e.g. interest on deferred tax liabilities) or the erosion of the investment component of their interest in the underlying share award (which will be the case if the deferral mechanism taxes the difference between the sale price and the employee's contribution, rather than establishing the point at which the shares are held without substantial conditions and taxes that value).

5. Widely offered share purchase schemes

Officials view is that the existing widely offered share purchase scheme regime appears to undermine fairness. The Issues Paper also notes the regime can be complex, inflexible and is out of date. Officials' preference is therefore to repeal the concessionary regime.

We consider that the concession for widely offered share purchase schemes is a valuable alternative and would benefit with modernising, instead of repeal.

A key benefit of the current rules is the simplicity associated with those share benefits being non-taxable, particularly where the shares are held by all levels of employees, including those who may be relatively unsophisticated. This effectively means the shares can be issued with no tax consequences (e.g. the need to be included in tax returns). Removal of the concessionary status is likely to result in employees, who would otherwise have straightforward tax affairs, having to manage the associated burden of compliance obligations.

Another advantage is that it encourages participation and engagement in the fate of the business by employees at every level. If the concessionary treatment of such shares is removed, it will become necessary for participants to finance their tax obligations arising from share awards. Based on our understanding, current practice for most participants in normal ESS is to fund their tax obligations for share awards out of their personal funds. In a number of cases, sell-to-cover arrangements may also be in place, however these rely on a liquid market. (There is also some sensitivity in the market to having executives regularly disposing of share awards.) For more junior employees, funding tax payments could be onerous and have the perverse effect of dis-incentivising ESS participation by such employees.

Our recommendation is to modernise the widely offered share purchase scheme regime to make it fit for purpose in the current environment.

KPMG submissions

- The existing cap of $2,340 over three years should be increased to a more realistic level (we recommend $15,000, subject to a lower cap in certain circumstances) to ensure that there is value in the awards to employees, and to employers in offering shares under the regime.
- We agree that there is little policy justification for the deemed interest deduction where an employer provides a widely-offered share purchase scheme.
- Employers should have the ability to differentiate between full time and part time employees in relation to the share awards.
- We agree that it may be appropriate to apply a cap in some circumstances to limit the amount of awards that can be provided tax-free.

6. Transitional issues

We support the proposal to provide transitional rules for existing ESS, to provide certainty as to their tax treatment.

The proposed transitional rules will need to be clear, in their application, as employers will potentially need to operate parallel systems for shares granted under the existing rules (that are grandfathered) and shares that are subject to the new rules.

Our preference therefore is for a simple rule which allows shares to be granted under existing schemes under the existing rules for a period. There should be no subsequent application of the new rules if the shares are awarded prior to a specific date. This date should be at least 18 months after the enactment of any rule to allow new schemes to be developed and to allow the effect of the new rules on existing schemes to be determined.

7. Administration, record keeping and reporting

The Issues Paper outlines proposals for reporting of additional ESS benefit information to supplement the measures contained in Taxation (Transformation: First Stage Simplification and Other Measures) Bill.

As a result of the mandatory disclosure obligations which will apply from 1 April 2017, Inland Revenue will receive details of the amount of any ESS benefits which an individual has received, whether or not the employer has elected into the PAYE regime for such benefits. We believe that this information should be sufficient for Inland Revenue to confirm the status of benefits declared as taxable.

We acknowledge that this will not provide Inland Revenue with any information for ESS which are considered to produce no taxable benefit for the employee.

We consider that a simple declaration by an employer of:

- the existence of an ESS;
- whether there are any benefits considered taxable and deductible, and if so, when that occurs: and
- the number of employees who participate (with annual updates once disclosed)

should be sufficient for Inland Revenue's risk analysis purposes. This is particularly the case because the employer will be entitled to a deduction equal to the employee's taxable benefit.

While we understand the desire for greater real-time information in relation to ESS benefits, this needs to be balanced against the greater compliance burden for employers. Inland Revenue's Business Transformation changes to PAYE should support greater real-time access to ESS information over time. However, this will be a long term process.

Under the new rules, employers' payroll teams will need to track the different taxing points for different employees, depending on when their substantial conditions cease. This will not be a straight forward exercise. This partly informs our recommendation for retaining the widely-offered share purchase concessionary regime, which is a relatively simple option for employers looking to offer an ESS.

KPMG submission

- Additional compliance obligations for businesses should be kept to a minimum and any information collected should have a clear purpose.
- The mechanism for reporting such benefits should be easy to administer and not adversely impact upon existing reporting systems.

We note in this regard that there is currently a lack of clear guidance for employers regarding how the new ESS disclosure rule will be applied in practice. In our view much of the reluctance to elect into the PAYE regime relates to the practical difficulties with completing the EMS for ESS benefits.

8. Issues Paper Analysis

The Issues Paper makes a number of assertions and provides a number of examples. We make some specific comments.

Equivalence of taxing on grant and exercise

The Issues Paper takes its options analysis as support for its position that there is no taxation of capital gains and that employees should be indifferent to taxation at grant or exercise.

The example does not show that there is no taxation of capital gains.

This conclusion is drawn from the fact that the tax rate is the same for the case when the shares increase in value. This simply means that if gains are comprehensively taxed, the rate is the same. This is not the same as not taxing capital gains. This should be readily apparent from applying the same analysis to a bond with assumed interest and a change in interest rates which produce a capital gain (ignoring the financial arrangement rules). If the gain is not taxed, the tax rate will not be the same. (We have not researched the literature in any detail but we expect that a cursory review would suggest that the option theory principles quoted in the Issues Paper assumes a comprehensive taxation regime and not one which distinguishes between revenue and capital gains).

Further, the example and conclusion completely ignores the position when the shares decrease in value. In that case, the tax rate moves from 33% to 0%. The 0% is applied to the loss in value. Contrary to the statement that there is no taxation of capital gains, this result denies a capital loss. This taxes capital gains. If the principles being asserted where consistently applied, this loss is in fact an employment loss. The employee should receive a deduction for this loss. To be explicit:

- All returns are due to employment;
- This is on revenue and taxable account;
- Gains as well as losses should be within the tax net.

In our view, the analysis does not establish that the proposed regime achieves neutrality. Given that it taxes employment and investment income, the basis for doing so is not neutrality. It can only be supported on other grounds.

We can see those grounds as being:

- Simplicity and cost – there are no valuation difficulties of taxing on exercise;
- Fairness – the taxing point matches the realisation point when the option is convertible to cash.

If that is the basis for the proposal this needs to be made explicit rather than a simple and in our view incorrect assertion that capital gains are not taxed.

For completeness:

- we agree that an employee may prefer taxation on exercise. However, that is not because of the equality of tax rates but because, as the example illustrates, they may pay tax when there is no realised benefit. Further, if there is no realised benefit, the loss is not deductible to offset that tax payment. This is reflected in our submission that the ability to be taxed on realisation should be available to employees.
- we acknowledge that that the proposal would allow the employer a deduction for a capital loss should the shares increase in value. That is why we consider it important that the Issues Paper's conclusions are corrected so the effect of the policy decision is clearly made. This will prevent future arguments by Inland Revenue that the employer is incurring a non-deductible capital loss when the share price increases for non-employment related reasons.

Ignoring the tax on bonus repayments and down side risk protection

At a number of points, the Issues Paper excludes the tax effects of bonuses paid to repay loans. In our view, this is material to the analysis of whether the right result arises.

In effect, we consider that the loan with bonuses schemes, are equivalent to a conditional cash bonus of the grossed up loan. It has the same effect. The after-tax amount is the amount available to the employee to repay the share purchase loan or otherwise do with as they please (e.g. invest).

The tax results are supportable on the basis that this is the agreed remuneration between the employer and the employee. This approach to separating employment and investment returns may not be perfect but it is a simple way of bifurcating the returns.

This means that loan to repaid from bonuses should be treated in the same way as a contingent cash bonus of the grossed up loan. This is how the current rules apply. There is no case for change if that is the outcome.

However, this leaves the problem of downside risk protection. We acknowledge that this is an employment related benefit. (We note in passing that the Issue Paper seems to ignore the commentary on FBT for employment related loans. That commentary suggests that an interest-free loan is equivalent to an "at interest loan" which would be assessable/deductible so that the tax effects can be ignored for FBT purposes.)

The financial arrangement rules, which have priority, would tax downside risk protection if it is provided in the form of a loan remission. Without wishing to repeat the debates on the Commissioner's view on debt remission, it appears that the Commissioner has a view that an arrangement which prevents debt remission is outside parliament's contemplation. We assume that the Issues Paper's approach means that the Commissioner does not have any such concerns in respect of the downside risk protection measures described in the Issues Paper.

This means that the financial arrangement rules do not tax these measures. The question is how they should be taxed. Despite our concerns with the options analysis in the Issues Paper, it seems that such benefits should be taxed on exercised consistent with our view that there should be an election to tax options on realisation.

An employment package with investment returns

We understand that the justification for conditional and option-like treatments is that the employer provides a package of shares and loan. This is said to justify the deferral of the taxing point to when the conditions (the loan) are removed.

Inconsistently, the proposal retains the treatment of dividends paid on the shares while the conditions apply.

Despite Officials apparent view that everything is employment related and there are no capital/investment effects to be accounted for, dividends are to retain their nature. This is inconsistent with the neutrality principle and the conclusion that everything is employment related. On the Issues Paper's analysis, the dividends should be treated as employment remuneration. A deduction should be allowed to the employer and PAYE should be deducted.

Designing a system which does this in practice would not be straight-forward. For example, the grossed-up dividend would be the remuneration and no imputation credits could be attached.

The point is simply that the Issues Paper itself acknowledges that an ESS has investment as well as employment aspects. If those two elements are not separated, an ESS is not properly, neutrally taxed under current tax policy settings.

If the elements are not separated this must be due to a justifiable trade off from the desirable position.

KPMG Submission

- The Issues Paper does not coherently establish the case for the proposals. Given our concerns regarding certainty, further thought should be given to a more coherent regime.

9. Consequentials

The Issues Paper raises a number of issues but provides no clear proposals. These include the position of employee share trusts.

These other issues are important and no less difficult than the taxation of an ESS benefit itself.

KPMG Submission

- These other issues should be considered and consulted upon more fully. They should not be left to consultation through the Select Committee Bill process.