Taxation of employee share schemes: start-up companies
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Possible changes to taxation rules for start-up and tech sector

Dear David

Thank you for the opportunity to comment on the taxation of employee share schemes: start-up companies consultation document (the **Consultation Document**). This submission is made jointly by Angel Association of New Zealand and PwC.

We appreciate that Inland Revenue recognises that start-up technology companies are key generators of economic growth, and that the treatment of employee share schemes (**ESS**) are a relevant consideration for them.

However, we consider that the deferral regime proposed in the Consultation Document would not have a material impact on the sector as the economic outcome of the proposed regime can already largely be achieved by way of an options scheme, without potentially negative tax outcomes deferral could create, or the complexities of a deferral regime.

All legislative references in this submission are to the Income Tax Act 2007.

1. Scope of reform

The stated purpose of the release of the Consultation Document is to "test whether there is appetite for a deferral regime and, if so, how one might operate in practice". We submit that the deferral regime does not present a particularly attractive option for start-ups for reasons expanded upon below. Further, while we understand the current policy intent is not to create a concession, in our view, if the Government's goal is to promote economic growth then aligning the treatment of ESS in New Zealand to what we have seen adopted overseas would make New Zealand start-ups more internationally competitive in attracting key talent and drive economic growth for New Zealand. In our view the proposed deferral regime will not achieve this objective as it does not compare favourably to start up regimes in other geographies.

Firstly, the deferral regime would only be beneficial if a liquidity event actually arises. Also, the result proposed by the deferral can already be accomplished with long-dated options.

Secondly, we consider that the focus of the current Consultation Document is too narrow, and misaligned with the Government's broader goals of economic growth and increased productivity. One of the key challenges faced by New Zealand start-ups is talent attraction. The proposed deferral regime does not address this point and therefore is no more commercially attractive than the current regime.

At present, employees are taxed (usually) at 39% on the increase in the difference between the market value of shares acquired when options are exercised and the exercise price for the options. Options are usually exercised at a liquidity event as most option holders do not want to fund the income tax liability before a liquidity event as there is significant risk whether value will be created in the future from a liquidity event, however a certain tax liability is created. In Australia, a 50% capital gains tax (**CGT**) discount applies to ESS for start-ups. A similar 50% discount is available in Canada. In the United Kingdom, CGT is only payable on gains over £100,000 in the tax payer's lifetime. In the United States, the proceeds on sales of shares are subject to CGT rates of up to 15% for most individuals where the shares are held for over a year. New Zealand's approach taxes ESS income at a significantly higher rate than other comparable markets.

This 39% effective tax rate on ESS income is much higher than other comparable countries and makes ESS less attractive for companies and participants as a tool to attract, reward and retain talent. Also, it means ESS are less effective in managing cashburn as the effectiveness of ESS to reduce salary costs is greatly reduced. This in turn means New Zealand companies are less capital efficient, which impacts their performance and likelihood of success.

On this basis we submit that the current policy scope of the Consultation Document does not sufficiently address the concerns of the start-up sector, and suggest that a broader lens is taken, considering the Government's broader goals around economic growth. We strongly recommend that officials assess how ESS benefits are taxed in comparable overseas countries and assess how competitive our settings are for attracting, retaining and rewarding talent and capital efficiency.

Furthermore, the proposed deferral regime largely delivers the same economic outcome as an options scheme but potentially with more complexity. Unless there are more concessions included, we do not consider there to be a sufficient case to support the introduction of the deferral scheme.

However, if the deferral scheme is pursued at this stage, we make the following high-level comments on some of the key design features. Furthermore, we would like the opportunity to provide further comments on the final design if the scheme is to proceed.

2. Definition of start-up

We submit that the definition of a 'start-up company' considered in the Consultation Document is not necessarily appropriate. Rather than looking at annual turnover and years of operation, we suggest that a definition could instead be determined with reference to characteristics such as losses and reliance on external funding.

If the turnover and years of operation are to be relied on, we submit that the thresholds be reconsidered. We understand the proposed turnover threshold of only $15 million per annum has been based on the relative market size of New Zealand. We submit that given start ups compete and operate globally, this smaller threshold base is not fit-for-purpose. We propose that the threshold be aligned to the New Zealand Dollar equivalent of the Australian threshold of AUD $50 million, which is circa NZD $55 million.

Additionally, while we note the Australian definition includes a maximum 10 year age threshold, given the economic conditions of New Zealand it is not uncommon for New Zealand start-ups to take longer than overseas counterparts to reach an appropriate liquidity event. We submit that if such a window is applied, the time period should be 15 years.

3. Other technical submissions

It is critical, if any deferral regime is adopted, that no tax liability arises for participants if they receive no value, and that they therefore have the ability to “opt out” of the ESS tax deferral arrangement without tax consequences (provided they receive no consideration for opting out). For example, if an employee ceases employment or the sunset date is reached without a sale of the shares, the legislation should allow employees to give up their share entitlement for nil consideration without tax consequences for either the employee or the company). In our view, if the legislation does not include this feature, it will be very unattractive and unlikely to be utilised other than in very limited circumstances.

Similarly, if a recipient is granted equity (as part of a reallocation of the capitalisation table for future capital raises) we submit that the tax payable should be deferred until a successful liquidity event. This would enable the start-up to offer shares in lieu of a portion of salary. This is on a similar basis to our submission above that it would make New Zealand start-ups more competitive globally.

Thank you for taking into consideration our comments. Please let us know if you would like to discuss any of the above further with us.

Yours sincerely

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Partner