

# *Commissioner's Statement CS 17/01*

## **Determining "value" of shares received by an employee under a share purchase agreement**

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*The purpose of a Commissioner's Statement is to inform taxpayers of the Commissioner's position and the operational approach being adopted on a particular tax matter. A Commissioner's Statement is not a consultative document.*

All legislative references are to the Income Tax Act 2007 ("the Act").

### **Introduction**

1. Changes to the Income Tax Act 2007, which came into force on 1 April 2017<sup>1</sup>, introduce new reporting rules for employers when shares are issued<sup>2</sup> to employees pursuant to a share purchase agreement ("SPA").
2. The new reporting rules require employers to report the value of any share benefit received by an employee under an SPA in the relevant employer monthly schedule ("EMS") for which the share benefit arises. In addition, the new rules also allow employers to elect to withhold PAYE on share benefits received by employees.
3. In order to comply with the new obligations, an employer will need to determine the **value of the share benefit** received by each employee under an SPA.
4. Having regard to the requirements of the law, valuation uncertainties and employer compliance costs, the Commissioner will accept the methods of valuation set out in this Statement provided that the SPA is conducted on arm's length commercial terms.
5. While this Statement provides taxpayers with safe harbour valuation methodologies which the Commissioner will accept, this Statement will not apply to any arrangements which are subject to any anti-avoidance provisions in the Act.
6. This Statement also provides guidance in regard to the information the company<sup>3</sup> should retain to support the valuation (in addition to any constitutional and Companies Act 1993 requirements).
7. This guidance relates to the new provisions and any other aspects of the current provisions relating to the valuation of shares acquired by an employee under an SPA.

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<sup>1</sup> The Taxation (Transformation: First Phase Simplification and Other Measures) Act 2016.

<sup>2</sup> Note that the phrase "shares are issued" refers to shares (or rights to shares) which are issued or transferred to an employee.

<sup>3</sup> Please note that "company" refers to the employing company even if the shares in question are issued or transferred to the employee by another entity.

8. This Statement is not intended to provide a definitive and comprehensive set of valuation techniques, and so companies may still apply other valuation methodologies that determine the value of the share benefit. If another valuation methodology is used by a company, the valuation must reflect the market value of the shares on the acquisition date.

### **Employment Income**

9. Benefits received by an employee under an SPA are employment income.
10. An SPA is defined in section CE 7 of the Act as:

...an agreement to dispose of or issue shares in a company to an employee that is entered into in connection with the employee's employment or service, whether or not an employment relationship exists when the employee receives a benefit under the agreement.
11. An SPA involves the acquisition of shares in a company by an employee (or another person for the benefit of an employee). These cover a wide range of share schemes and may involve the immediate transfer of shares, the granting of share options or deferred share schemes where shares vest or are transferred at a later date.
12. A taxable share benefit arises when an employee acquires shares under an SPA and the amount paid by the employee for the shares is less than the market value of the shares.
13. Section CE 2 of the Act determines the value of the benefit the employee receives and the allocation of the benefit to a particular year.
14. Section CE 6 of the Act outlines when shares are acquired by an employee ("acquisition date") under an SPA.
15. Section CE 6(2) provides that, for the purposes of sections CE 2 to CE 4 and CE 7:
  - (a) shares are treated as having been acquired on the date on which the right or option to acquire them is exercised; and
  - (b) if shares or rights are acquired or transferred under an agreement by a trustee for the benefit of an employee to whom section CE 2 applies, the employee is treated as having acquired or transferred the shares or rights.
16. The obligation to report the value of a share benefit and the election to withhold PAYE is limited to share benefits arising under sections CE 2(2) and CE 2(4) of the Act.
17. Section CE 2(2) relates to shares acquired by an employee under an SPA:

If an employee acquires shares under a share purchase agreement, the value of the benefit to the employee is the amount by which the value of the shares when they were acquired is more than the amount paid or payable for them. The employee receives the benefit in the income year in which they acquire the shares.
18. Section CE 2(4) relates to shares acquired by an associated person of the employee under an SPA:

If, following 1 or more transactions between associated persons, an associated person acquires the shares under a share purchase agreement, the value of the benefit is the difference between the value of the shares on the date of acquisition by the associated person and the amount paid or payable for them. If the difference is negative, the value is zero. The employee receives the benefit in the income year in which the associated person acquires the shares.

### **Value of Share Benefit**

19. In order to determine the value of the share benefit arising for an employee or associated person, an employer will need to determine the following:
  - The value of shares on acquisition date; and
  - The amount paid or payable for them.
20. The Act does not define "value", nor does it prescribe any methods for determining the value of shares acquired under an SPA.
21. The Commissioner considers the term "value" for the purpose of section CE 2 refers to the market value amount at which the shares would be exchanged between two non-associated third parties, on an arm's length basis. This value is required to be determined even if the shares cannot be sold or there is no market for the shares.
22. For completeness, the definition of "market value" in section YA 1 does not apply to this Statement.

### **Acceptable Valuation Methods**

23. Where the company adopts one of the methods outlined in this Statement and retains the necessary documentation to support the valuation, the Commissioner will accept the share value and therefore the benefit ascribed to the employee under section CE 2.
24. Absolute accuracy is not expected in all scenarios (as accuracy depends in part to the data sets available and in some situations on subjective judgement), but it is expected that a reasonable, appropriate process is followed when determining the share value at the time the shares are issued.
25. It is also expected that the valuation method and any input assumptions used to prepare the valuation should be fully documented and retained as the Commissioner may request to examine the documentation.
26. Where a company adopts a method not outlined in this Statement, the company should retain the documentation outlining the reasons for adopting the alternative method as the Commissioner may request to examine the documentation.
27. The methods which the Commissioner will accept will depend on the type of shares issued to the employee under an SPA – shares in a listed company; shares in an unlisted company; or shares in an unlisted start-up company.
28. Outlined below are the methods the Commissioner will accept for the three types of shares.

## Listed Shares

29. Where the company issuing shares to an employee has shares listed on a "recognised exchange" the Commissioner will accept the share value reached (applicable to the class of shares, and any rights attaching to them, to which an SPA applies) using one of the following methods:
- **Option A:** Volume weighted average price ("VWAP") over the last five trading days (including the acquisition date) for the listed share; or
  - **Option B:** Closing Price of listed share on the acquisition date; or
  - **Option C:** If on the acquisition date the employee disposes of the shares at market value on a recognised exchange, the actual proceeds of sale on that date and, if the proceeds of sale are in a foreign currency, the New Zealand Dollar equivalent by applying the close of trading spot price exchange rate on the sale date.

### Recognised Exchange

30. A recognised exchange is defined in section YA 1.
31. Outlined below are the relevant factors included in the section YA 1 definition:
- A recognised exchange market in New Zealand or anywhere else in the world which has the following features:
    - the exchange market brings together buyers and sellers of shares or options over shares; and
    - the exchange market involves the listing of prices, whether by electronic media or other means, at which persons are willing to buy or sell shares or options; and
    - the exchange market provides a medium for the determination of arm's length prices likely to prove fair and reasonable, having regard to—
      - the number of participants in the market or having access to the market; and
      - the frequency of trading in the market; and
      - the nature of trading in the market, including how prices are determined and transactions are effected; and
      - the potential or demonstrated capacity of a person or persons significantly to influence the market; and
      - any significant barriers to entry to the market; and
      - any discrimination on the basis of quantity bought and sold unless based on the risks involved, the transaction costs, or economies of scale

### Volume Weighted Average Price ("VWAP")

32. The VWAP for a share is calculated by adding up the dollars traded for every



### Information Requirements

38. The company should retain information that can support the share value and method, being able to supply the relevant documentation to the Commissioner on request. The following information should be retained:
- If Option A is used, VWAP calculation and supporting listed price data; or
  - If Option B is used, closing market listed price data; or
  - If Option C is used, documents evidencing the sale and currency conversion and, where an independent third party undertakes the sale and any subsequent conversion of the proceeds to New Zealand Dollars, that third party's advice of the New Zealand Dollar equivalent of the transaction will suffice; or
  - If newly listed shares, published offer price; or
  - If foreign listed shares, relevant offer or listed price data and the spot FX rate used.

### **Unlisted Shares**

39. Where the company issuing shares to an employee has unlisted shares (not including a start-up company which is defined for the purposes of this guidance below) the Commissioner will accept the share value reached (applicable to the class of shares, and any rights attaching to them, to which an SPA applies) using one of the following methods:
- **Option A:** An arm's length value determined by an independent, suitably qualified valuer which conforms with generally accepted practice<sup>4</sup>; or
  - **Option B:** A valuation (based on the company's most recent arm's length commercial transaction in the last six months prior to the acquisition date) involving the issue or sale of the same class of shares to a non-associated third party (for example, a previous capital raising or sale of a parcel of shares) where, if new shares are being issued to employees the valuation is adjusted for dilution of existing shares; or
  - **Option C:** A valuation method prepared by an appropriate person in the company using an appropriate method (this option and the requirements to use this option is explained further below).

### Dilution Effect When Issuing New Shares

40. All methods should take into account the diluting effect of issuing new shares to employees, particularly if using Option B.

*Example: Company A has previously issued 1m shares to non-associated third parties for \$1m. Subsequently, Company A issues 100,000 new shares to employees for no consideration. The value of the shares will be calculated as follows:*

*Total consideration paid for shares issued \$1m / total shares issued 1.1m = \$0.91 per share.*

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<sup>4</sup> For the purposes of paragraphs 39 and 50, "generally accepted practice" means a valuation prepared under AES-2 (Business Valuation Engagements) issued by CA ANZ or an equivalent valuation engagement standard.

### Foreign Company

41. If the unlisted shares are held in a foreign company, the foreign value determined in accordance with the above options will need to be converted to its New Zealand Dollar equivalent by applying the close of trading spot exchange rate on the acquisition date of the shares by the employee.

### Previous Valuation

42. The Commissioner will accept a value based on the most recent valuation prepared by a company using option A, B or C if:
  - The valuation is for the same class of shares as the shares issued to the employee; and
  - The valuation was prepared within a period not exceeding six months prior to the acquisition date of the shares by the employee.
43. This Statement will not apply where a company uses a previous valuation and adjustments are made to the original share value resulting in a lower value (discounting). This Statement will also not apply where the previous valuation relates to shares of a different class to the shares issued under the SPA.

### Information Requirements

44. The company should retain information that can support the share value and method, being able to supply the relevant documentation to the Commissioner on request. The following information should be retained:
45. If Option A is used:
  - A copy of the independent valuation report received by the company.
46. If Option B is used:
  - Documentation supporting the value of the shares issued or sold to the non-associated third party (for example, copy of sale and purchase agreement or capital raising documentation); and
  - Confirmation the shares are of the same class; and
  - Approval of the valuation in writing by one member of the Board of Directors or the Chief Financial Officer or the Chief Executive Officer of the company confirming that in their opinion the valuation reflects the market value of the shares issued to the employee at the taxing date.
47. If Option C is used, refer to detailed information requirements below.

### Option C: Internally Prepared Valuation Requirements

48. If a valuation is prepared internally by the company, the company should retain all the following information:
  - A copy of the internally prepared valuation;

- That the valuation was prepared by a person employed by the company who has the necessary financial skills, qualification and experience to prepare a valuation;
- That the valuation is based on an appropriate method. The Commissioner considers the following methods are appropriate methods:
  - Discounted Cash Flow (DCF); or
  - Capitalisation of Earnings;
- Contemporaneous documentation supporting all workings, input assumptions and comparable data used to prepare the valuation. This should include the following information (where applicable):
  - Financial information used to determine earnings (for capitalisation of earnings method) or future cash flows (for DCF method), including (but not limited to):
    - prior year financial statements;
    - current operating results;
    - cash flows and future oriented financial information such as budgets, forecasts and projections;
  - Documentation supporting any normalising adjustments;
  - Documentation supporting discount rates;
  - Documentation supporting capitalisation rates or earnings multiples (including any comparable data used to determine earnings multiples);
  - Reasoning and support for any discounts or premiums;
- That the valuation has been approved in writing by one member of the Board of Directors or the Chief Financial Officer or the Chief Executive Officer of the company confirming that in their opinion the valuation reflects the market value of the shares issued to the employee on the acquisition date or alternatively, that the valuation has been reviewed and agreed with by an independent, suitably qualified valuer appointed or instructed by the Board of Directors;
- A copy of the independent valuation opinion (if applicable).

### **Shares in an Unlisted Start-up Company**

49. The following approach can be applied where the company issuing shares to an employee is a start-up company. This generally means a company which:
- is in the first stage of its operations; and
  - initially financed and operated by founding shareholders or investors; and
  - has not paid any dividends; and



- its expenses tend to exceed their revenues and may be yet to produce a profit; and
  - tend to have very low net tangible assets; and
  - may have a high level of expended research and development costs relative to its tangible assets value; and
  - does not yet have a stable market for its product or service.
50. The Commissioner will accept the following methods for valuing start-up company shares:
- **Option A:** An arm's length value determined by an independent, suitably qualified valuer which conforms with generally accepted practice; or
  - **Option B:** A valuation (based on the company's most recent arm's length commercial transaction in the last 12 months prior to the acquisition date) involving a share issue or sale of the same class of shares to a non-associated third party (for example, a previous capital raising or sale of a parcel of shares) where, if new shares are being issued to employees the valuation is adjusted for dilution of existing shares; or
  - **Option C:** A valuation method prepared by an appropriate person in the company using an appropriate method (this option and the requirements to use this option is explained further below). Option C will not be available if the company has a previous valuation under Option A or a recent issue/sale of shares under Option B.

Venture Capital Funding

51. Given the complexities associated with share valuations for venture capital funding rounds, this Statement will not apply to a company with a current or proposed (i.e. is intended to take place within six months of acquisition date of shares by employee) venture capital funding round<sup>5</sup>. The company should obtain a separate arm's length valuation for any shares issued to employees under an SPA where venture capital funding is involved.

Previous Valuation

52. The Commissioner will accept a value based on the most recent valuation prepared by a company using option A, B or C if:
- The valuation is for the same class of shares as the shares issued to the employee; and
  - The valuation was prepared within a period not exceeding 12 months prior to the acquisition date of the shares by the employee.
53. This Statement will not apply where a company uses a previous valuation and adjustments are made to the original share value resulting in a lower value. This

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<sup>5</sup> Venture capital funding round means funding by a venture capital fund or firm (including Series A funding rounds). It does not include seed funding from private investors.

Statement will also not apply where the previous valuation relates to shares of a different class to the shares issued under the SPA.

Information Requirements

54. The company should retain information that can support the share value and method, being able to supply the relevant documentation to the Commissioner on request. The following information should be retained:
55. If Option A is used:
  - A copy of the independent valuation report received by the company.
56. If Option B is used:
  - Documentation supporting the value of the shares issued or sold to the non-associated third party (for example, copy of sale and purchase agreement or capital raising documentation); and
  - Confirmation that the shares sold to the non-associated third party are of the same class as SPA shares and have the same rights attached to them; and
  - Approval of the valuation in writing by one member of the Board of Directors or the Chief Financial Officer or the Chief Executive Officer of the company confirming that in their opinion the valuation reflects the market value of the shares issued to the employee at the taxing date.
57. If Option C is used, refer to detailed information requirements below.

Option C: Internally Prepared Valuation Requirements

58. If a valuation is prepared internally by the company, the company should retain all the following information:
  - A copy of the internally prepared valuation;
  - That the valuation was prepared by a person employed by the company who has the necessary financial skills, qualification and experience to prepare a valuation;
  - That the valuation is based on an appropriate method. The Commissioner considers the following methods are appropriate methods:
    - Discounted Cash Flow (DCF);
  - Contemporaneous documentation supporting all workings, input assumptions and comparable data used to prepare the valuation. This should include the following information (where applicable):
    - Financial information used to determine future cash flows including (but not limited to):
      - prior year financial statements;
      - current operating results;

- cash flows and future oriented financial information such as budgets, forecasts and projections;
- Documentation supporting any normalising adjustments;
- Documentation supporting discount rates;
- Documentation supporting capitalisation rates;
- Reasoning and support for any discounts or premiums;
- That the valuation has been approved in writing by one member of the Board of Directors or the Chief Financial Officer or the Chief Executive Officer of the company confirming that in their opinion the valuation reflects the market value of the shares issued to the employee on the acquisition date or alternatively, that the valuation has been reviewed and agreed with by an independent, suitably qualified valuer appointed or instructed by the Board of Directors;
- A copy of the independent valuation opinion (if applicable).

### **Application**

59. This Statement provides general guidance to assist taxpayers in meeting their tax obligations. This approach can be used by taxpayers for, and will be applied by the Commissioner to, shares acquired by employees on or after 1 April 2017.
60. If you have any concerns about your compliance with the tax obligations discussed in this Statement, you should discuss the matter with an appropriately qualified tax professional.

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