

QUESTIONS WE'VE BEEN ASKED > GENERAL ISSUES

# When an employer is party to an employee share scheme, when does an employer's expenditure or loss under s DV 27(6) or income under s DV 27(9) arise?

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QB 21/04

This "Question We've Been Asked" (QWBA) is relevant to any employer who is party to an employee share scheme where the employee receives a benefit under the scheme within 20 days of:

- the end of the employer's income year; or
- a breach of shareholder continuity in the employer (for example, due to an employee share scheme winding up as a result of an acquisition).

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

## Key provisions

Income Tax Act 2007 – ss CE 2 and DV 27

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## Question

When an employer is party to an employee share scheme (ESS), when does an employer's expenditure or loss under s DV 27(6) or income under s DV 27(9) arise?

## Answer

When an employer is party to an ESS, the employer's expenditure or loss under s DV 27(6) or income under s DV 27(9) will arise when the related "employee amount" from the formula in s DV 27(7) is recognised for the ESS employee.

The "employee amount" is the amount for the ESS employee calculated on the share scheme taxing date in accordance with the formula in s CE 2(1). Where the amount calculated is:

- negative, the ESS employee has a deduction **on the share scheme taxing date** (subject to any applicable general limitations, other than the employment limitation);
- positive and the employer has an employee benefit reporting obligation in respect of the ESS employee, then the ESS employee derives the amount **on the ESS deferral date**; and
- positive and the employer does not have an employee benefit reporting obligation in respect of the ESS employee, then the ESS employee derives the amount **on the share scheme taxing date**.

This QWBA does not consider arrangements that may be subject to the application of ss BG 1 (Tax Avoidance) or GB 49B (Employee Share Schemes).

## Key terms

**Employee benefit reporting obligation** means the requirement to provide employment income information under s RD 22(3) of the Income Tax Act 2007 and ss 23E to 23H of the Tax Administration Act 1994, as modified by s 23K of the Tax Administration Act 1994, in relation to a benefit received under an ESS.

**Employee share scheme** (ESS) has the meaning given in s CE 7. Broadly, an ESS (subject to specified exceptions) is an arrangement with a purpose or effect of issuing or transferring shares in a company to a person (an **ESS employee**) who will be, is, or has been an employee (or shareholder–employee) of that company or of another company in the same group, if that arrangement is connected to the person's employment or service. It also includes the provision of shares to an associate of the ESS employee, if the arrangement is connected with the ESS employee's employment or service.

**ESS deferral date** means the 20<sup>th</sup> day after the share scheme taxing date for the benefit.

**Share scheme taxing date** has the meaning given in s CE 7B. Broadly, this date is the earlier of the following dates (subject to specified exclusions):

- The first date when the shares are held by or for the benefit of an ESS employee (or associate) and, after which, under the provisions of the ESS, 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;
  - no benefit accruing to the ESS employee (or associate) in relation to a fall in value of the shares; and
  - no material risk that there will be a change in the terms of the shares affecting the value of the shares.
- The date when the shares or related rights of an ESS employee (or associate) are cancelled or are transferred to a person who is not associated with an ESS employee.

## Explanation

1. A new regime for the taxation of employee share schemes (ESSs) came into force on 29 September 2018 (enacted by the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Act 2018).
2. The objective of the new regime is to ensure neutral tax treatment of ESS benefits as compared with other forms of employee remuneration. That is, to the extent possible, the tax position of both the employer and the employee should be the same whether remuneration for labour is paid in cash or shares.

### Employee amounts – s CE 2

3. Section CE 1(1)(d) provides that a benefit received under an employee share scheme in connection with a person's employment or service is income of the person.
4. Section CE 2(1) provides that an ESS employee receives a benefit for the purposes of s CE 1(1)(d) equal to the positive amount calculated on the share scheme taxing date using the following formula:

$$\text{share value} - \text{consideration paid} + \text{consideration received} - \text{previous income.}$$

5. The terms used in the formula are defined in s CE 2(2). Broadly, the terms have the following meanings:

- **Share value** is the market value of the shares or related rights owned by an ESS employee or associate on the share scheme taxing date, if the share scheme taxing date is not triggered by a transfer or cancellation of the shares or related rights.
  - **Consideration paid** is the amount of consideration paid or payable by an ESS employee or associate in relation to the transfer of the shares or related rights under the ESS.
  - **Consideration received** is the amount of consideration paid or payable to an ESS employee or associate in relation to a transfer or cancellation of the shares or related rights under the ESS.
  - **Previous income** is the total amount of income under s CE 1(1)(d) that the ESS employee has in relation to the shares or related rights before 29 September 2018.
6. While the formula in s CE 2(1) is calculated on the share scheme taxing date, s CE 2(7) to (9) provides that if the employer has an employee benefit reporting obligation in respect of the benefit (a positive amount calculated using the formula), then the ESS employee is treated as deriving employment income in relation to the benefit on the ESS deferral date (20 days later).
7. If the formula in s CE 2(1) results in a negative amount (for example, because the share value on the share scheme taxing date is less than the consideration paid in relation to the transfer), ss CE 2(3) and DV 27(4) provide that it is a deduction for the ESS employee. Section DV 27(4) supplements the general permission and overrides the employment limitation (see s DV 27(10)). The ESS deferral date under s CE 2(7) to (9) applies only to benefits (positive amounts calculated using the formula in s CE 2(1)); that is, not negative amounts.

### Employer amounts – s DV 27

8. Subject to the general permission (s DA 1) and general limitations (s DA 2), a deduction is available to employers for ESS benefits that matches the income to employees in timing and quantity, as explained in [9] to [21].
9. Where an employer is party to an ESS and is the employing or contracting company for an ESS employee, s DV 27(6) effectively provides that the employer has an amount of expenditure or loss equal to the positive amount calculated in accordance with the formula in s DV 27(7):
- $$\text{employee amount} - \text{previous deductions.}$$
10. The terms used in the formula are defined in s DV 27(8). Broadly, the terms have the following meanings:
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- **Employee amount** is the amount for the ESS employee calculated under the formula in s CE 2(1). This could be a positive or negative amount.
  - **Previous deductions** is the total amount of deductions that have been allowed to the employer or an associate for expenditure or loss incurred in relation to the employee amount before 29 September 2018.
11. If the result of the formula in s DV 27(7) is a negative amount then, instead of expenditure or loss under s DV 27(6), the amount is income of the employer under ss DV 27(9) and CV 20.
  12. The employer's expenditure or loss under s DV 27(6) is generated by the formula in s DV 27(7). Section DV 27(2) denies a deduction for most other expenditure or loss on an ESS – for example, payments to an ESS trust or reimbursements paid to a parent for issuing shares.

### Timing

13. The uncertainty addressed in this QWBA arises because timing under s DV 27 for the expenditure or loss under s DV 27(6) or the income under s DV 27(9) arising for the employer is unclear. Ordinary principles for when expenditure is incurred or income is derived cannot be applied given the nature of the expenditure or loss arising under s DV 27(6). The expenditure or loss does not relate to any actual cost, outlay or receipt, but is created by the formula in s DV 27(7). The obligations under the ESS may not even be obligations of the employer – for example, it may be a parent company required to issue shares or make payment to the employee under the ESS. If some form of actual cost or outlay is incurred by the employer, s DV 27(2) generally denies a deduction for most of those costs or outlays.
14. The main feature of the formula in s DV 27(7) is the "employee amount" that is calculated for the ESS employee on the share scheme taxing date under s CE 2(1).
15. As set out in [5] to [7], the recognition of the "employee amount" by the ESS employee is deferred by 20 days (to the ESS deferral date) under s CE 2(7) to (9) where the employer has an employee benefit reporting obligation in respect of the benefit (being a positive amount calculated under s CE 2(1)). In such a case, the benefit is treated as paid on the ESS deferral date under s RD 6(3)(a) of the Income Tax Act 2007 and s 23K(1) of the Tax Administration Act 1994.
16. An employer will usually have an employee benefit reporting obligation for a benefit under s RD 22. An exception is where the ESS employee is a former employee for whom the employer has not chosen under s RD 7B to withhold an amount of tax.

17. The above circumstances lead to uncertainty as to whether the employer's expenditure or loss under s DV 27(6) or income under s DV 27(9) arises on the share scheme taxing date or the ESS deferral date.
18. Purpose and context are relevant for determining the meaning of a provision (in light of s 5 of the Interpretation Act 1999, *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36 at [22] to [24] and *CIR v Alcan New Zealand Ltd* (1994) 16 NZTC 11,175 at [444]). In light of the purpose and context of the new ESS regime and s D 27, the Commissioner considers that the employer's expenditure or loss under s DV 27(6) or income under s DV 27(9) resulting from the application of the formula in s DV 27(7) arises at the same time the related "employee amount" calculated under s CE 2(1) and used in s DV 27(7) is recognised.
19. This is because the purpose and context of the new ESS regime demonstrate that the share benefit is to be taxed in the same way as an equivalent cash payment followed by an acquisition of shares in the issuing company. This is shown in ss CE 2 and DV 27 for income and deductions arising under an ESS, and in s CD 43(6E) to (6K) for the related adjustments to the calculation of the employer's available subscribed capital. These provisions apply as follows:
  - The ESS employee is treated as receiving the share benefit when they have done everything they need to earn the shares and hold them in the same way as any other shareholder. This occurs through the calculation of the benefit being performed on the share scheme taxing date: ss CE 2(1) and CE 7B.
  - The employer is treated as incurring an equivalent cost at the same time as the employee recognises the income. The deduction to employers is to match the income to employees in timing and quantity. This occurs through the calculation of the deduction being linked to the "employee amount" under s DV 27(6) to (8).
  - The employer (in the usual case) has an uplift in its available subscribe capital under s CD 43(6E) to (6K) at the same time.
20. The recognition of the benefit by the ESS employee is deferred by 20 days (to the ESS deferral date) under s CE 2(7) to (9) when an employer has employee benefit reporting obligations. This period is to allow employers time to compile and report the relevant information. Where that deferral applies, the recognition of the amount calculated for the employer under s DV 27(7) must also be deferred in that manner. While the benefit can be calculated as at the share scheme taxing date, the employer has not "incurred" anything in respect of the amount calculated under s DV 27(7) at that time. The employer does not have any obligations existing for the expenditure or loss under s DV 27(6) prior to s DV 27 creating it.

## Examples

21. The following examples are of a general nature and assume the general permission (s DA 1) is met and the general limitations (s DA 2) to deductibility do not apply.

### Example 1 – Simple option: market value increasing

On 1 April 2020, A Co issues an option to its employee to subscribe for 10,000 shares in A Co for an exercise price of \$1 (being the market value of a share in A Co on 1 April 2020). The option may be exercised only after 31 March 2023, provided the employee has been in continuous employment with A Co for the three-year period from when the option was issued. The employee exercises their option on 15 July 2023 and is issued shares on the same day.

The share scheme taxing date is when the option is exercised and shares are issued to the employee on 15 July 2023. The market value of the shares on 15 July 2023 is \$15,000. The exercise price paid by the employee for the shares is \$10,000.

The employee's benefit of \$5,000 is calculated in accordance with s CE 2(1) on 15 July 2023.

If the employer has employee benefit reporting obligations for the benefit, the employee is treated as deriving employment income of \$5,000 under ss CE 1(1)(d) and CE 2 on the ESS deferral date of 4 August 2023. The related employer expenditure or loss under s DV 27(6) also arises on 4 August 2023.

If the employer does not have employee benefit reporting obligations for the benefit (for example, because, after having been in continuous employment with A Co for three years, the employee leaves employment before exercising the option and A Co has not elected to withhold an amount of tax), s CE 2(7) to (9) and the ESS deferral date do not apply, and the employee is treated as deriving employment income of \$5,000 under ss CE 1(1)(d) and CE 2 on the share scheme taxing date of 15 July 2023. The related employer expenditure or loss under s DV 27(6) also arises on 15 July 2023.

### Example 2 – Simple option: market value decreasing

This example uses the same facts as in example 1, except the market value of the shares on 15 July 2023, the share scheme taxing date, is \$9,500. The exercise price paid by the employee for the shares is still \$10,000.

The employee's deduction of \$500 is calculated and arises on the share scheme taxing date of 15 July 2023 in accordance with ss CE 2 and DV 27(4).

The related employer income of \$500 under ss DV 27(9) and CV 20 also arises on 15 July 2023.

## References

### Legislative references

#### **Income Tax Act 2007**

Sections BG 1, CD 43(6E) to (6K), CE 1(1)(d), CE 2, CE 7, CE 7B, CV 20, DA 1, DA 2, DV 27, RD 6(3)(a), RD 7B, RD 22

#### **Tax Administration Act 1994**

Sections 23E to 23H, as modified by s 23K

#### **Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Act 2018**

#### **Interpretation Act 1999**

Section 5

### Case references

*Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36

*CIR v Alcan New Zealand Ltd* (1994) 16 NZTC 11,175

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