Inland Revenue
Te Tari Taake

QUESTIONS WE'VE BEEN ASKED | PĀTAI KUA UIA MAI

Fringe benefit tax – employee share loans and associates

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QB 24/03

This question we've been asked explains whether the employee share loan exclusion from fringe benefit tax can apply when an associate of the employee enters into a loan to acquire shares in connection with the employee's employment.

Key provisions | Whakaratonga tāpua

Income Tax Act 2007, ss CX 2, CX 10, CX 35, GB 32

Question | Pātai

Does a fringe benefit arise where a trustee of a family trust that is associated with an employee is provided a loan to acquire shares under an employee share scheme?

Answer | Whakautu

No, a fringe benefit does not arise in this situation, provided that a fringe benefit would not arise if the employee were provided the loan to acquire the shares under the employee share scheme in the same circumstances.

Explanation | Whakamāramatanga

Introduction

1. An employee share scheme (ESS) is defined in s CE 7. Broadly, it is an arrangement with a purpose or effect of issuing or transferring shares in a company to an employee if it is in connection with the employee's employment or service. An ESS includes providing shares to an associate of an employee, if that is done in connection with the employee's employment or service. Where an associate receives the shares, it is still the employee that receives any employment income from the ESS under s CE 1(1)(d) and s CE 2.

2. The terms of an ESS may provide for making an interest-free loan to the employee to enable them to purchase the shares under the ESS. Where an employer (or another person by arrangement of the employer) provides an interest-free loan to an employee in connection with their employment, it is generally a fringe benefit unless an exclusion applies. Relevantly, loans under an ESS are often made on terms that fall within the "employee share loan" exclusion from fringe benefit tax (FBT). An employee share loan is a loan provided to an employee for the sole purpose of enabling them to acquire shares in the employer or group company, provided certain criteria are met.

3. When a benefit is provided to an associate of an employee, it is treated as provided to the employee (and a fringe benefit) as long as it would be a fringe benefit if it was provided to the employee.

4. We have been asked whether the employee share loan exclusion from FBT can apply when a trustee of a family trust (Trustee) that is an associate of the employee enters into the loan and acquires the shares under the terms of the ESS, instead of the employee.

The answer

5. The Commissioner considers that where a loan is provided to a Trustee that is an associate of the employee in circumstances that would satisfy the employee share loan exclusion if the Trustee were the employee, the loan will not give rise to a fringe benefit. For the purposes of this question we've been asked (QWBA), it is assumed that the employee is a participant in an ESS and, under the terms of the ESS, the employer (or another person by arrangement with the employer) makes a loan to the Trustee on the following terms:

   - The loan must be used for the sole purpose of the Trustee acquiring shares in a company that is the employer or an associate of the employer.
   - The Trustee uses the loan only for the purpose of the acquisition.
   - The Trustee maintains beneficial ownership of the shares throughout the term of the loan. "Beneficial ownership" in the context of the employee share loan exclusion is discussed from [37] to [41].
   - The Trustee must immediately repay the loan in full if it ceases to have beneficial ownership of the shares.

6. For the purposes of this QWBA, the following assumptions also apply:

   - The ESS is not an "exempt ESS" (as defined in s CW 26C).
   - The employer and employee are not associated (under the definition of "associated" in s YA 1).
   - The company whose shares are subject to the ESS maintains a dividend paying policy through the term of the loan and is not a "qualifying company" or a "look-through company" (as each of those terms is defined in s YA 1).
   - The Trustee is associated with the employee under the definition of "associated" in s YA 1.

7. For completeness, the Commissioner acknowledges that the above analysis could apply to other associates of the employee as well – for example where the above facts and assumptions are satisfied by the employee's spouse, civil union partner or de facto partner.

8. This QWBA does not consider the implications of any anti-avoidance provisions and the outcomes set out may not apply where the general anti-avoidance provision (s BG 1) applies.

What is a fringe benefit?

9. Section CX 2 defines fringe benefit:

> **CX 2 Meaning of fringe benefit**
>
> *Meaning*
>
> (1) A **fringe benefit** is a benefit that—
>
> (a) is provided by an employer to an employee in connection with their employment; and
>
> (b) either—
>
> (i) arises in a way described in any of sections CX 6, CX 9, CX 10, or CX 12 to CX 16; or
>
> (ii) is an unclassified benefit; and
>
> (c) is not a benefit excluded from being a fringe benefit by any provision of this subpart.
>
> *Arrangement to provide benefit*
>
> (2) A benefit that is provided to an employee through an arrangement made between their employer and another person for the benefit to be provided is treated as having been provided by the employer.
>
> *Past, present, or future employment*
>
> (3) It is not necessary to the existence of a fringe benefit that an employment relationship exists when the employee receives the benefit.
>
> *Relationship with subpart RD*
>
> (4) Sections RD 25 to RD 63 (which relate to fringe benefit tax) deal with the calculation of the taxable value of fringe benefits.
>
> *Arrangements*
>
> (5) A benefit may be treated for the purposes of the FBT rules as being provided by an employer to an employee under—
>
> (a) section GB 31 (FBT arrangements: general):
>
> (b) section GB 32 (Benefits provided to employee's associates).

10. Section CX 2(1) states that a fringe benefit is a benefit that is provided by an employer to an employee in connection with their employment, that arises under a specific provision or is an unclassified benefit, and that is not specifically excluded by a provision in subpart CX.

11. The remainder of s CX 2 broadens the scope of fringe benefit in the following ways:

- Where a benefit is provided to an employee by someone other than the employer, it is treated as having been provided by the employer if it is provided by arrangement with the employer: s CX 2(2).
- It is not necessary for an employment relationship to exist when the employee receives the benefit: s CX 2(3).
- A benefit may be treated as provided by an employer to an employee under s GB 31 (specific anti-avoidance rule where an arrangement is entered into to defeat the intent and application of the rules) or s GB 32 (where a benefit is provided to an associate that would be a fringe benefit if provided to an employee): s CX 2(5).

12. Therefore, in analysing the implications of a Trustee associated with an employee obtaining a loan to acquire shares under an ESS, this QWBA considers in turn:

- applying the FBT rules to a loan;
- applying the FBT rules to an associate; and
- applying the FBT rules to the scenario set out in this QWBA.

Applying the FBT rules to a loan

13. Section CX 10 states:

> **CX 10 Employment-related loans**
>
> *When fringe benefit arises*
>
> (1) A fringe benefit arises when an employer provides a loan to an employee.
>
> *Exclusions*
>
> (2) Subsection (1) does not apply to a loan made—
>
> (a) as an employee share loan:
>
> …
>
> *Loan owing*
>
> (3) The employer provides a fringe benefit in a tax year in which the loan is owing. The circumstances in which a loan is owing include a case in which, under the arrangement for the loan, an amount is payable in the future, or would be payable in the future if a particular event happened, and the employee or an associated person is or would be liable to pay the amount.

14. Accordingly, a loan that an employer (or another person by arrangement of the employer) provides to an employee in connection with their employment is generally a fringe benefit under ss CX 2 and CX 10 unless an exclusion applies. Relevantly, it will not be a fringe benefit if it is an employee share loan as s CX 10(2)(a) sets out.

15. Section YA 1 provides that an "employee share loan" is defined in s CX 35, which in turn states:

> **CX 35 Meaning of employee share loan**
>
> *Meaning*
>
> (1) Employee share loan means a loan made to an employee if—
>
> (a) the loan is made for the sole purpose of enabling the employee to acquire, under a scheme of acquisition,—
>
> (i) shares, rights, or options in the company that is their employer:
>
> (ii) shares, rights, or options in a company that is associated with their employer; and
>
> (b) the employee uses the loan only for the purpose of the acquisition; and
>
> (c) the employee beneficially owns the shares, rights, or options throughout the term of the loan; and
>
> (d) the employee must immediately repay the loan in full if they stop being the beneficial owner of any of the shares, rights, or options; and
>
> (e) the company issuing the shares, rights, or options must maintain a dividend-paying policy throughout the term of the loan.
>
> *Exclusions*
>
> (2) This section does not apply—
>
> (a) to shares, rights, or options in a qualifying company:
>
> (b) to a loan made under an exempt ESS:
>
> (c) to an employer and an employee who are associated persons.

16. The requirements of s CX 35(1) demonstrate the purpose of the FBT exclusion for employee share loans is that FBT should not arise for a low-interest loan where an employee obtains the loan to acquire an income-earning asset. This is because s CX 35(1) effectively requires the loan to be used, and used only, for the purpose of acquiring shares where the company maintains a dividend paying policy. This is further supported by a requirement that the employee is the beneficial owner over the term of the loan. This means the employee cannot obtain the use of the loaned funds for

another purpose by retaining legal ownership in the shares while selling beneficial ownership.

17. The above purpose apparent from the terms of s CX 35(1) is reflected in the material surrounding the introduction of the FBT exclusion. Section CX 35 was originally enacted in 1996 as the definition of an "employee share loan benefit" in s OB 1 of the Income Tax Act 1994. The commentary on the Taxation (Remedial Provisions) Bill (May 1996) provided the rationale for introducing the employee share loan exclusion from FBT:

> The bill introduces two further specific exclusions from fringe benefit tax (FBT). The exclusions relate to employee share purchase plan (ESP) loan benefits and tax assistance given to employees. **The exclusions allow certain fringe benefits to be provided to employees without incurring FBT because an employee would have been able to get a deduction had he or she actually incurred the expense.**
>
> ...
>
> The bill introduces two specific exclusions to the fringe benefit definition in section CI 1 of the Income Tax Act 1994:
>
> - An exclusion for loan benefits **if the sole purpose of the loan is to enable the employee to acquire shares in the employer** under an ESP;
>
> ...
>
> Some situations have been identified where the **payment of FBT** on the benefits which are the subject of the FBT exclusions provided for in this amendment **would result in overtaxation**. This arises **if an employee would have been entitled to a tax deduction for the expenditure incurred on the provision of the fringe benefit**. In most cases this can be avoided by structuring the provision of the fringe benefit in a different way. The exclusions provided for in the bill remove the need to restructure the provision of these benefits. [Emphasis added]

18. The requirements of s CX 35(1) and the apparent purpose of the employee share loan exclusion from FBT emphasise the importance of the loan being used for the sole purpose of obtaining shares under the ESS. Interest on a loan being generally deductible when used to acquire an income-earning asset underlies the FBT exclusion. To apply FBT to the loan benefit in such circumstances would likely result in over-taxation.

19. For completeness, if the employee borrowed the funds to acquire the shares and then transferred those shares to an associate, it is clear the s CX 35 FBT exclusion would not apply. This is because the employee would not retain ownership of the shares while

the loan is outstanding. In terms of the underlying purpose of the employee share loan FBT exclusion, any interest on the loan would not have been deductible by reason that the employee incurred it in deriving their assessable income, because it is the associate that would be deriving any dividend income from the shares.

Applying the FBT rules to an associate

20. As set out in s CX 2(5)(b), a benefit may be treated for the purposes of the FBT rules as being provided by an employer to an employee under s GB 32. This is relevant if the employee's associate (the Trustee) obtains the loan to acquire the shares under the ESS.

21. Section GB 32 states:

> **GB 32 Benefits provided to employee's associates**
>
> *When this section applies*
>
> (1) This section applies when—
>
> (c) a benefit is provided to a person who is associated with an employee of an employer; and
>
> (d) the benefit would be a fringe benefit if provided to the employee; and
>
> (e) the benefit is provided either by the employer or by another person under an arrangement with the employer for providing the benefit; and
>
> (f) the exemptions in subsections (2) and (2B) do not apply.
>
> ...
>
> *Benefit treated as provided to employee*
>
> (3) For the purposes of the FBT rules, the benefit is treated as provided by the employer to the employee.
>
> ...

22. If a benefit provided to the Trustee meets the requirements of s GB 32(1), and the exemptions set out in s GB 32(2) and (2B) do not apply to the benefit (such exemptions are not relevant to the scenario in this QWBA), then under s GB 32(3) the benefit is treated as provided by the employer to the employee for the purposes of the FBT rules. This means even though the benefit is provided to an associate rather than the employee, it would give rise to FBT.

23. The purpose of s GB 32 is clear from its requirements and its placement in subpart GB as a specific anti-avoidance provision. The FBT rules cannot be avoided by providing a

benefit to an employee's associate in connection with their employment, rather than to the employee directly. Such benefits are treated as fringe benefits under s GB 32, so long as they would be fringe benefits if they were provided to the employee.

24. Section GB 32 was originally enacted as s 336N(3) in the Income Tax Act 1976. *Public Information Bulletin* Part 1, Number 136 (May 1985) provided commentary on the newly enacted FBT rules. It states the following about s 336N(3):

> - Benefits provided to associated persons of the employee
>
> Section 336N(3) provides that "... where any benefit which, if it were provided for or granted to an employee would be a fringe benefit, is provided or granted by the employer of the employee, or is provided or granted by another person with whom the employer of the employee has entered into an arrangement for the providing or granting of that benefit, for or to a person other than the employee of the employer, the employee of the employer and the other person being associated persons, that benefit shall be deemed to be a benefit provided for or granted to the employee by the employer of the employee. "
>
> The effect of this provision is that **the fringe benefit tax legislation applies to any benefit provided to an associated person of an employee in the same manner as if that benefit had been provided to the employee**. **As this deeming provision applies for the purposes of the whole of the fringe benefits tax legislation, references in the legislation to benefits provided to an employee should be read as including benefits provided to an associated person of the employe[e]**. [Emphasis added]

25. This commentary is consistent with the purpose of s GB 32. As demonstrated by the requirements of s GB 32, that purpose is to ensure the FBT rules can apply to a benefit provided to an associate in the same manner as if that benefit had been provided to the employee. For this to occur, the provisions of the FBT rules need to be able to work where the benefit is provided to an associate rather than the employee. The commentary to the new FBT legislation in the *Public Information Bulletin* suggests that this is achieved by reading references in the FBT rules to benefits provided to an employee as including benefits provided to an associate.

26. Where a loan is provided to an associate of an employee on the terms set out at [5] and [6], s GB 32(1) would apply as follows:

- A benefit (the loan) is provided to a person (the Trustee) associated with an employee of the employer (s GB 32(1)(a)).
- The benefit (the loan) is provided by the employer or another person under an arrangement with the employer (s GB 32(1)(c)).
- The exemptions in s GB 32(2) and (2B) do not apply (s GB 32(1)(d)).

27. Accordingly, the key question is whether "the benefit would be a fringe benefit if provided to the employee", as s GB 32(1)(b) sets out. If it would be a fringe benefit in these circumstances, the FBT rules will apply to the benefit under s GB 32(3). If it would not, the FBT rules will not apply because a benefit is not treated as being provided to an employee.

Applying the FBT rules to the scenario set out in this QWBA

28. If the employee rather than the Trustee had obtained the loan and acquired the shares on the terms set out at [5] and [6], the loan would meet the requirements of s CX 35 to qualify as an employee share loan. It would not be a fringe benefit under s CX 10(2)(a).

29. The question is whether the exclusion for employee share loans set out in ss CX 10(2)(a) and CX 35 can apply where the loan is provided to the Trustee. In other words, can the exclusion apply when determining whether the loan provided to the employee's associate "would be a fringe benefit if provided to the employee" for the purposes of s GB 32(1)(b)?

30. The context of the ESS rules, the FBT rules and the underlying purposes of the exclusion for employee share loans (s CX 35) and the extension of the rules to benefits provided to associates (s GB 32) is important. In this context, the Commissioner considers it is necessary to determine whether the loan to the Trustee would be a fringe benefit if provided to the employee by reading references to the employee in s CX 35 as being references to the associate.

31. For a fringe benefit to arise if a benefit is provided to an associate, it must be in circumstances where that benefit would give rise to a fringe benefit for the employee. For the FBT rules to apply to a benefit provided to an associate in the same manner as if that benefit had been provided to the employee, the same exclusions set out in the FBT rules that apply to the employee must be able to apply to the benefit the associate obtained.

32. In other words, where the Trustee has received the benefit (the loan – s CX 10, satisfying s GB 32(1)(a)), treating the associate as the employee for the purposes of applying s CX 35, would that give rise to a fringe benefit (and in that way satisfy s GB 32(1)(b))?

33. This approach is consistent with the purpose underlying both ss CX 35 and GB 32. As outlined from [16] to [18], the purpose of s CX 35 is to ensure FBT is not applied where an employee would likely have been allowed a deduction for interest incurred to acquire an income-earning share, because imposing FBT in such circumstances would result in over-taxation. Where the Trustee obtains a loan to acquire shares with a

dividend paying policy, the Trustee would likely have been allowed a deduction for costs associated with the loan (in the same manner as the employee). Accordingly, interpreting the requirements of s CX 35 as relating to an employee or the associate for the purposes of applying s GB 32 allows the purpose of s CX 35 to be met.

34. Further, this approach is consistent with the apparent purpose of s GB 32 outlined from [23] to [25]. The loan is not being provided to the Trustee rather than the employee to avoid FBT. If the employee were to obtain the loan to acquire the shares under the ESS instead of having the Trustee do this, the loan would not be subject to FBT due to the application of s CX 35.

35. Therefore, in order to determine whether the loan provided to the Trustee would be a fringe benefit if provided to the employee under s GB 32(1)(b), the Commissioner reads references to the employee as references to the associate in s CX 35. The requirements of s CX 35 are therefore as follows:

- Is the loan made for the sole purpose of enabling the associate to acquire, under a scheme of acquisition:
  - shares, rights or options in the company that is the employer; or
  - shares, rights or options in a company that is associated with the employer?
- Does the associate use the loan only for the purpose of the acquisition?
- Does the associate beneficially own the shares, rights or options throughout the term of the loan?
- Must the associate immediately repay the loan in full if they stop being the beneficial owner of any of the shares, rights or options?
- Does the company issuing the shares, rights or options maintain a dividend paying policy throughout the term of the loan?

36. On the assumptions set out at [5] and [6], the loan the Trustee obtains to acquire the shares under the ESS would meet the requirements of s CX 35. This is because the loan is tied to the acquisition and beneficial ownership of the shares, and the company maintains a dividend paying policy. Accordingly, the benefit would not be a fringe benefit if it was provided to the employee and s GB 32(3) will not treat the provision of the benefit as provided by the employer to the employee. This means no FBT will arise.

Comment on whether the Trustee can "beneficially own" shares for the purposes of s CX 35(1)(c)

37. In terms of general trust law, a trustee is often referred to as holding legal title of assets in respect of which the beneficiaries of the trust have beneficial ownership. However, s CX 35 simply refers to the employee acquiring shares and having beneficial ownership of the shares during the term of the loan. It does not only apply to situations involving trusts.

38. Courts that have considered "beneficially owns", or similar terms, caution that it must be interpreted in context and in light of the purpose of the section in which it occurs. As Gallen J concluded in *Martin v Martin* [1988] 1 NZLR 722 (HC) at 731 (approved in *FCT v Linter Textiles Australia Ltd (In Liq)* 2005 ATC 4,255 at [50]):

> In my view, it follows from the cases that the term "beneficial ownership" is to be construed in context and must reflect the purposes of the section in which it occurs.

39. Consistent with the above judicial comment, courts have interpreted "beneficially owns" in different ways depending on the context in which the phrase is used. For example, various cases concerning succession duty have held that persons holding funds to apply in a particular way on trust for a purpose have had a beneficial interest in the funds. For example, in *Perpetual Trustees, Estate, and Agency Co of New Zealand, Ltd v Commissioner of Stamp Duties* [1927] NZLR 714, Stringer J delivering the judgment of the Court of Appeal held that a church had a beneficial interest in a bequest to the church that was to be applied for the purposes of its foreign missionary work. Stringer J discussed a number of cases that had considered a person holding funds on trust for a purpose, or to be applied in a particular manner, as being beneficially entitled for the purposes of succession duty.

40. In the context of employee share schemes and in terms of the purpose of s CX 35 described at [16] to [19] and the requirements of the section, what is essential is the nexus, or degree of connection, between the interest expense and the dividends and the acquisition of shares. This indicates that the requirement for the employee to "beneficially own" the shares means the employee must own the rights that give the shares value, in particular the rights to dividends. This interpretation is consistent with the purpose of preventing employees from selling the rights carried by the shares and using the proceeds for a different purpose. However, given many employee share schemes involve restrictions on an employee's ownership of shares for a certain period, it might be expected that the employee does not have the right to dispose of the shares during the term of the loan or call for legal title.

41. Where a trustee of a family trust holds the shares in accordance with the deed establishing the family trust and is entitled to the fruits of ownership of those shares (eg dividends and voting) to direct and control for the purposes of the family trust in line with the trust deed, the trustee should be considered beneficial owner of those shares in the context of and for the purposes of s CX 35. For this reason, we consider the trustee of a family trust, in their capacity as trustee of the family trust and applying funds in accordance with the terms of the trust, may be a beneficial owner of the shares for the purposes of s CX 35(1)(c) and (d).

References | Tohutoro

Legislative references | Tohutoro whakatureture

Income Tax Act 1976, s 336N(3)

Income Tax Act 1994, s OB 1 ("employee share loan benefit")

Income Tax Act 2007, ss BG 1, CE 1(1)(d), CE 2, CE 7, CW 26C ("exempt ESS"), CX 2 ("fringe benefit"), CX 10, CX 35 ("employee share loan"), GB 32, YA 1 ("associated", "qualifying company", "look-through company")

Case references | Tohutoro kēhi

Martin v Martin [1988] 1 NZLR 722 (HC)

FCT v Linter Textiles Australia Ltd (In Liq) 2005 ATC 4,255

Perpetual Trustees, Estate, and Agency Co of New Zealand, Ltd v Commissioner of Stamp Duties [1927] NZLR 714

Other references | Tohutoro anō

Commentary on the Taxation (Remedial Provisions) Bill (May 1996)

Public Information Bulletin Part 1, Number 136 (May 1985)

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