

PRODUCT RULING - BR Prd 04/04

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by McBreen Jenkins Construction Limited (“McBreen”).

Taxation Laws

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of sections BG 1, CD 5, CH 2, CH 3, EB 1 and GB 1.

This Ruling does not consider the tax implications (if any) arising in respect of contributions made by McBreen to employees of associated companies of McBreen, or any tax implications (if any) arising in respect of any benefits derived by those employees of associated companies of McBreen.

This Ruling does not consider the application of section DF 7 or the implications of this provision (if any) on interest free loans made by McBreen to the Trust under the Arrangement.

The Arrangement to which this Ruling applies

The Arrangement is the establishment and operation of the McBreen Jenkins Construction Limited Employee Option Plan (“EOP”) for the benefit of the employees of McBreen in New Zealand. The EOP will be implemented through the establishment of a trust (“the Trust”). The Trustee of the EOP will be TMG Trustees (NZ) Limited, a New Zealand registered company (“the Trustee”).

The Trust Deed (“the Trust Deed”), the Plan Rules and the Employee Share Option Contract (“Contract”) provided to the Commissioner of Inland Revenue on 1 March 2002 together form the Arrangement subject to this Ruling. Further details of the Arrangement are set out in the paragraphs below.

McBreen

1. McBreen is incorporated in New Zealand. It is one of New Zealand’s leading civil engineering organisations. At the time of issuing this Ruling it employs a workforce of around 500 employees and is noted for successful completion of the more difficult and complex construction projects.

Establishment of the EOP

2. McBreen will select certain employees and direct the Trustee to invite those employees to enter into a Contract. The Contract is a contract between the Trustee and the employee under which the employee can acquire options to purchase shares from the Trustee (“Options”). The shares will generally be McBreen shares, purchased directly from the company (ie. as fresh share issues) or from existing shareholders. However, where McBreen shares are unavailable or are inappropriate given the purpose of the EOP, other shares may be purchased on the New Zealand Stock Exchange or other shares approved by McBreen (“the Shares”).
3. In terms of the source of shares to be acquired by the Trust, it is necessary to undertake a threefold process, being:
 - (a) valuation of shares;
 - (b) creating a warehouse for shares (ie. The EOP); and
 - (c) creating a market for shares (ie. The EOP).

Source of Shares

4. Firstly, it is anticipated that there will be two sources of shares for the EOP, that is:
 - Plan A ESOT shares, which will be shares in McBreen; and
 - Plan B ESOT shares will be in an associated investment/finance company of the McBreen Jenkins Group.
5. To commence the plan, all shares will be sourced from fresh issues – ie. it is not envisaged that initial acquisitions of shares by the Trustee would be acquired from existing shareholders. However, there have been situations in past employee share plans where founding directors have wished to sell shares and the employee share plan acquired those shares at an arm’s length market value. Also, over time as employees acquire shares and sell those shares the EOP trust, as the prime market for EOP shares, will issue options, acquire shares, issue shares to employees under the terms of the EOP and purchase shares from employees.
6. It is proposed to earmark around 35% of McBreen’s issued capital for utilisation by the Plan A ESOT. However, given McBreen’s circumstances as an unlisted company, with limitations as to its issued capital, it is necessary to establish a subsidiary or associated company to provide further equity under the Plan B ESOT.
7. The shares issued under Plan A ESOT will involve the more key and skilled employees of McBreen’s operation, while the Plan B ESOT will provide equity to the remaining employees as a general employee share plan.

8. If an employee takes up the invitation to join the EOP they will become a participating employee (“Participant”). The Participant will then enter into an agreement with their employer, McBreen, that as a consequence of entering into the Contract with the Trustee they will agree to sacrifice a part of their salary (i.e. a reduction of up to 25% of their pre-tax total fixed remuneration). This agreement may also include giving up the right to any future and contingent bonuses and any future contingent incentive payments. This can either be a percentage reduction or a specific figure.

9. McBreen will execute an addendum to their employment contract making provision for Salary Sacrifice, and amending the contract of employment, in the following terms:

I,..... have accepted an offer by the Trustee of the McBreen Jenkins Employee Option Plan, to participate in the Plan and to acquire the right to purchase shares from the Trustee, on the terms and conditions referred to in the Trust Deed and the Share Option Contract.

I authorise and accept a reduction in my pre-taxation monetary remuneration of an amount equal to the Employee Election (as defined in the Employee Share Option Contract) and I authorise and accept a reduction in any future and contingent bonuses or other future and contingent incentive payments of not more than the Employee Remuneration Election (as defined in the Employee Share Option Contract).

10. The remuneration package of McBreen employees is set each year in advance. Participants will be offered the choice of taking part of the total value of their remuneration package in cash salary, or benefits in kind, which may include Options under the EOP. The Options issued to Participants may replace some of the current incentives or performance based reward programmes of McBreen.

11. McBreen may also make additional payments to the Trustee to enable it to acquire further shares. These payments may arise from bonus offers.

Bonus offers

12. This will involve McBreen paying an amount, which would otherwise be paid as a salary bonus, to the Trust. The amount paid to the Trust will be determined as follows. McBreen sets a minimum operating turnover, less: wages, operating costs and overheads. Once the minimum operating turnover is achieved McBreen will set a “bonus pool” equivalent to 5% of the annual operating turnover and 30% of the “Participating Contribution”. The “Participating Contribution” is defined as operating turnover less direct wages and direct operating costs and overheads (plant operating costs and other variable costs and indirect operating wages and salaries, but not shareholder salaries). 100% of the “bonus pool” will be paid to the Trust. For example, if a bonus pool of \$90,000 were established, McBreen or an associated company of McBreen (being a company that is related to McBreen by virtue of section 2(3) of the Companies Act 1993) would make a contribution to the Trustee who would then acquire shares. The Trustee would then issue Options to the Participants.

13. The extent to which the Participants will receive the Options will be determined in accordance with the proportion of points allocated to each Participant. The points will be calculated as follows:
 - one point for every \$5,000 of gross taxable earnings; and
 - one point for each year of service to a maximum of 25 years of service.
14. McBreen may also use bonus offers to operate as long term incentives to the Participants. Long term incentives are used as a means of attracting key employees with particular expertise necessary for the ongoing performance and profitability of the organisation. They are usually structured so that key employees may be retained and “locked-in” by way of “golden handcuffs” (minimum non-exercise periods of say 3 to 5 years, which are set as a term of offer for particular option allocations).
15. Payments will be made from the “bonus pool” only if the company is left in a position of profit and its net assets backing is sufficient to meet its banking covenant. In some years no “bonus pool” would be generated, while in others bonus pools of varying amounts would be produced.

Operation of the Trust

16. The payments from McBreen to the Trust, arising from Salary Sacrifice and Bonus Offers will not exceed the following percentages, expressed as a percentage of a Participant’s total wages, salary or other remuneration in any one year:
 - in respect of Salary Sacrifice, up to 25%.
 - in respect of Bonus Offers, up to 30%.
17. These amounts received by the Trustee from the Salary Sacrifice and Bonus Offers will then be used to purchase the Shares.
18. Shares acquired by the Trustee will be purchased at their prevailing market values. The value of the shares will be reflected (i.e. indeed, costed to the Participants’ remuneration in lieu of bonuses and salary) on the basis of the cost price of shares acquired by the Trustee. It is this cost price which will be reflected and deducted from their remuneration entitlements. This may require Salary Sacrifice or debiting against annual remuneration or other performance remuneration (eg. bonuses, incentives, profit share etc).
19. The valuation of shares is set on the basis of net asset values on a times profitability (eg earnings, before tax), while also applying general principles “of true and fair value”, and maintaining “transparency”, and “integrity” in the calculation of the share value. McBreen has used quite simple valuation formula in the past. These have usually been provided by the company’s management. For example, there may be a “times earnings” ratio – eg. 2, 3 or 4 x EBIT (earnings before interest and tax). Alternatively, some companies may use net asset values.

20. However, as net asset values invariably equate to a net accumulated profit figure, companies have tended to use a “times” earnings basis.
21. The Options will be provided from the Trust to the Participants for nil consideration. The shares will be held in the Trust for the benefit of the Participants. Participants will, therefore, have a general beneficial interest in the shares held as the corpus of the Trust. These beneficial interests in the corpus of the Trust and the capacity to enforce due administration of that Trust will be complemented by the Contract.
22. Under the terms of the Trust Deed and Plan Rules of the EOP, the Participants will not have specific shares allocated to them or held on their behalf or for their benefit prior to exercise of the Options. Nothing in the EOP confers upon any Participants any rights in respect of the shares, including any right to instruct the Trustee how to vote or otherwise to deal with the shares. Prior to the Participant exercising their option to acquire shares and pay the stipulated consideration, the Trustee does not hold any of the shares for the benefit of any particular Participant.
23. In each of the ways Options may be acquired, payments made by McBreen and associated companies are for the purpose of remunerating the Participants for their services to McBreen or the associated companies. McBreen considers that the contributions are made in respect of the provision of services by Participants as part of their employment duties.
24. The Trustee may accumulate or decide to accumulate all or part of the income (including any dividends in respect of EOP shares) arising from the Trust in an income year. The accumulated income shall be added to the capital of the Trust so that it becomes part of the Trust and is held on the same trusts and with the same powers, but the Trustee may still resort to the accumulated income at any time and pay, apply, or appropriate all or part of it as if it were income of the Trust.
25. The Trustee may, and shall at the direction of the Participant, pay, apply or appropriate all or part of the income arising from the trust fund in an income year:
 - in meeting EOP expenses;
 - to one or more of the Participants; and/or
 - for any other purposes relevant to the EOP.

Any dividend income distributed as cash to the Participants will be on a pro-rata basis.

26. In some cases the payments made by McBreen will be in respect of employees who are employed by an associated company for reasons of administrative convenience, but will be reimbursed by those associated companies.

Administrative Contributions

27. McBreen will also provide the Trustee with sufficient funds (“Administrative Contributions”) to enable the Trustee to perform its obligations under the EOP. These Administrative Contributions will be made to the Trustee only for accounting fees, audit fees, investment management fees and trustee fees. These funds will be provided by way of grant. For financial reporting purposes, these payments made by McBreen to the Trustee for accounting fees, audit fees, investment management fees and trustee fees will be expensed in the year in which they are paid.

Loans

28. In some cases loans will be provided to the Trustee in lieu of contributions so as to reduce the effect of contributions on the profitability of the company. McBreen considers this also has the effect of deferring the time of tax deductibility on the contributions. For example, McBreen may not wish to have the contribution reflected in the profit and loss account, due to adverse perceptions of financiers or investment analysts. This is the usual means of spreading the costs of contributions over a number of years, rather than in any one particular year.

Participants exercising their Options under the EOP

29. The Contract is a contract between the Trustee and the Participant which governs the Participant’s right to exercise their Option and acquire the Shares. The Contract can only be exercised in respect of an “Unrestricted Share Option”. In some cases the Participants may be required to have achieved certain time or performance based contingencies before their Options become “Unrestricted Share Options” under the Contract. In particular there may be a set minimum vesting or non-exercise periods (eg. three years of continuous service and/or certain other performance criteria). Under the first proposed allocation, the non-exercise period will be for a period of one year from the date of entering into the Contract. Once this vesting or minimum vesting non-exercise condition is achieved, the Option becomes an “Unrestricted Share Option”, which may be exercised at the discretion of the Participant.
30. In order to exercise their Option under the Contract the Participant must give the Trustee an “Exercise Notice”. The Exercise Notice must specify the number of shares the Participant wishes to purchase and whether the Participant wishes to either:
- purchase the relevant shares from the Trustee; or
 - at the Participant’s election, request the Trustee to sell the relevant shares on behalf of the Participant and distribute the proceeds of the sale of the shares to the Participant.
31. In both cases, it will first be necessary for the Participant to exercise their Option under the Contract and pay the stipulated consideration of \$1.00 in

total. The right to acquire shares, which are the subject of an Unrestricted Share Option, is the subject of rules dealing with forfeiture.

32. The right to exercise the Options will be subject to the ongoing restrictions consisting of:
 - (a) The Plan Rules—the conditions applicable to the acquisition of the Shares by the Trustee and provision of Options under the terms of the trust are to be set out in the governing Plan Rules. The Plan Rules will govern the respective relationships between McBreen, participating employees and the Trustee.
 - (b) Paying for Shares—on vesting the Shares will be issued to the Participants for consideration.
33. Additionally, the Participant is also deemed to have given an Exercise Notice in the following circumstances:
 - ten years from date the Participant entered into the Contract;
 - termination of employment; or
 - termination of Trust.

If this situation occurs, the Participant will be required to pay the consideration of \$1.

34. Upon the receipt of a valid Exercise Notice, and receipt of a consideration of \$1.00, the Trustee shall either transfer the Shares in specie to the Participant or pay cash distributions to the Participant funded from the sale of the relevant Shares or from additional contributions from McBreen. The Shares or cash will be distributed to the Participant at a point in time contemporaneous with the exercise of the Option.
35. The number of shares which the Participant will be entitled to purchase will be calculated by dividing the amount of the Salary Sacrifice by the average price paid by the Trustee to acquire the shares for the purpose of the EOP over a one week period up to and including the day of the close of the offer to the Participant.
36. The number of shares to which the Participants are entitled will be adjusted under the terms of the Contract for any bonus offer or matching offer.
37. The Options will be operative for up to a maximum period of ten years from the date the Participant entered into the Contract or earlier on termination of employment. The ten-year limitation may be waived at the discretion of the Trustee (e.g. in cases of hardship).

Participants forfeiting their Options under the EOP

38. The Options will be subject to forfeiture and cancellation for nil consideration by the Trustee in situations of:

- Theft, fraud or defalcation by the Participant in respect of McBreen or one of its associated companies; and
 - Summary dismissal from McBreen or one of its subsidiaries.
39. If Options are forfeited by one Participant, it is intended that further Options will be issued to present or future Participants. The options are forfeited if the person has not served their required vesting or non exercise period. Forfeited options are usually cancelled and new options may be allocated in accordance with the remuneration purpose of each allocation.
40. Those allocations and the terms of those allocations (eg: the non-exercise or vesting period and the performance hurdles) which may be set depend on the purpose of the allocation. For example, a short term incentive may have a relatively short vesting period (eg: one (1) year), while a long term incentive would typically have a vesting or non-exercise period ranging from two (2) to five (5) years.
41. The plans are usually implemented on an “enabling” basis. That means that the employee is in a position to set varying terms and conditions of the vesting or non-exercise period depending on the particular remuneration purpose of the particular allocation.
42. The Options cannot be transferred or disposed of for cash.

Winding up of the Trust

43. In the event that the Trust is wound up, each Participant will be deemed to have exercised their Option under the Contract to purchase from the Trustee for a consideration not exceeding \$1.00 in total, and (at the Participant’s election) to receive the proceeds from the sale (by the Trustee) of shares subject to the Contract (for which the Participant has an Option).
44. If any shares or other assets remain, such shares and other assets, or the proceeds of their sale, will first be applied to meeting the costs and liabilities of winding up, and thereafter will be applied by the Trustee at the direction of McBreen to or for the benefit of any other employee incentive plan or scheme for the benefit of the employees. Pursuant to clause 8 of the Trust Deed the Trustee is prevented from applying the above winding up options in any way for the benefit of McBreen. It states:

8. Application of Plan Shares

- 8.1 Shares are to be held by the Trustee for the purposes of this Plan until sold by the Trustee to a Participating in accordance with the Participant’s right under a Share Option Contract.
- 8.2 Notwithstanding Rule 8.1, the Participating Employer may in its absolute discretion from time to time by notice in writing direct the Trustee to apply any Plan Shares in any one or more of the following ways:

- (a) to be transferred to any other incentive plan or scheme for the benefit of Employees in which the participating Employer or any Associated Company is not beneficially interested:
- (b) to be transferred to any superannuation or similar fund for the benefit of Employees in which the Participating Employer or any Associated Company is not beneficially interested.

Reasons for the EOP

45. The EOP will be a key part of McBreen's remuneration performance pay regime for its key executives and other deserving employees. The purpose is to attract, retain, and motivate such employees (quality years of service), and to act as a deterrent to theft or misbehaviour, and to give them a clear identity as shareholders in McBreen.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following condition:

- (a) The final documents will not differ in any material way from the documents provided to the Commissioner on 1 March 2002.

How the Taxation Laws apply to the Arrangement

Subject in all respects to any condition stated above, the Taxation Laws apply to the Arrangement as follows:

- When the Participants acquire the shares or the proceeds from the sale of the shares as a result of exercising their Options, the taxable value of the benefit will be gross income under sections CH 2 and CH 3.
- Under section CH 2(6), the Participants derive the gross income in respect of the shares or proceeds acquired under the EOP, on the date on which the Participants exercise their Options to acquire the shares from the Trustee.
- The taxable value of the benefit received by the Participants under section CH 2 is the difference between the amount paid for the shares, being \$1.00 (one dollar), and the market value of the shares on the day the Options are exercised by the Participants.
- The amount of the Salary Sacrifice agreed to by the Participants to satisfy the requirements of the EOP does not constitute gross income of the Participants under sections CD 5, CH 3, or EB 1.
- The amount of any contributions made by McBreen to the Trustee of the EOP does not constitute gross income of the Participants under sections CD 5, CH 3, or EB 1.
- Sections BG 1 and GB 1 will not apply to negate or vary the conclusions above.

This Ruling does not consider or rule on any aspect of the tax consequences (if any) that may arise from any payment, application or appropriation of all or part of the income arising from the Trust Fund to the Participants.

The period or income year for which this Ruling applies

This Ruling will apply for the period 15 March 2004 to 14 March 2009.

This Ruling is signed by me on the 15th day of March 2004.

Martin Smith

General Manager (Adjudication & Rulings)