TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKAWĀ

Employee Share Scheme – right to receive shares

Decision date | Rā o te Whakatau: 7 February 2024

Issue date | Rā Tuku: 30 April 2024

TDS 24/08

Subjects | Kaupapa

Income tax: Employee share scheme; share scheme taxing date

Taxation laws | Ture tāke

All legislative references are to the Income Tax Act 2007.

Facts | Meka

1. The Taxpayer was an employee of C Ltd (the Company). The Taxpayer was granted rights (Rights) to receive ordinary shares (Shares) in the Company under an employee share scheme (ESS) implemented by that company.
2. The Rights vested around 3 years after they were granted and, provided the Taxpayer was then an employee of the Company, they were entitled to receive a corresponding number of Shares and could exercise the Rights. The Taxpayer had until the end of the second fiscal year following the year in which the Rights vested to exercise the Rights.
3. The Rights granted to the Taxpayer vested in June 2020 and June 2021. The Taxpayer exercised all the Rights and sold all the Shares in April 2022.
4. The Company included the amount received from the sale of the Shares as employee share scheme (ESS) income derived by the Taxpayer in the employment information it filed with Inland Revenue for April 2022. This is consistent with the "share scheme taxing date" being in early April 2022 when the Taxpayer exercised the Rights.
5. The Taxpayer considered that the "share scheme taxing date" was when the Rights vested, and the employment information provided by the Company was incorrect. The taxpayer purported to amend their 2021 income tax return to include ESS income for the Rights that vested in June 2020 and in their 2022 income tax return included ESS income for the Rights that vested in June 2021.
6. Customer and Compliance Services, Inland Revenue (CCS) was on the view that the "share scheme taxing date" was in April 2022 when the Rights were exercised and proposed adjusting the Taxpayer's income tax returns to reflect this.
7. The Taxpayer disagreed and the matter was sent to the Tax Counsel Office, Inland Revenue (TCO) for adjudication.

Issues | Take

8. The main issue considered in this dispute was whether the "share scheme taxing date" was when the Rights vested or when the Taxpayer exercised the Rights.

Decisions | Whakatau

9. TCO decided that the "share scheme taxing date" was when the Rights vested.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: "Share scheme taxing date"

10. Under s CE 1 the amount of a benefit received under an ESS by a person is income of the person.

11. The amount of the benefit is the value of the shares at the "share scheme taxing date" less the amount paid for them.

12. The "share scheme taxing date" is also relevant in determining the time at which the income is derived. The income is treated as derived on the 20th day after the "share scheme taxing date".

13. Under s CE 7B "share scheme taxing date" means, in relation to shares or related rights under an ESS, the earlier of the following two dates:

    - The first date when shares are held by or for the benefit of an employee "(beneficial ownership)" and after which there is no material risk that beneficial ownership may change, no benefit accruing to employee in relation to a fall in value in the shares, and no material risk of a change in the terms of the shares affecting their value.
    - The date the employee's shares or related rights are cancelled or are transferred to a person who is not associated with the employee.

14. It was undisputed there was no material risk that beneficial ownership of the Shares may change or that any right or requirement in relation to the transfer or cancellation of the Shares may have operated. Accordingly, the share scheme taxing date fell to be determined based on the first date:

    - the Shares were held for the benefit of the Taxpayer (s CE 7B(1)(a)), and

- after which there was no material risk of a change in beneficial ownership of the Shares (s CE 7B(1)(a)(i)).

"When shares are held … for the benefit of an employee"

15. This means the shares must be held by the legal owner of the shares according to the company register, for the benefit of the employee. To hold shares for the benefit of someone means you are not beneficially the owner of the shares. The person for whose benefit you hold the shares is the beneficial owner.

16. Relevantly, an ESS is an arrangement with a purpose or effect of issuing or transferring shares in a company to an employee of the company or another company in the same group as the company.

17. Accordingly, an underlying premise of an ESS is the ultimate transfer of ownership of shares to an employee so that they become the legal owner. A person becomes the legal owner of shares when their name in entered in the company's share register as the holder of the shares.

18. Arguably, then, in s CE 7B(1(a), shares "held … for the benefit of an employee" are shares held by a person for the purposes of ultimately transferring the legal ownership of them to the employee.

No material risk that beneficial ownership may change

19. Under s CE 7B(1)(a), the relevant date is the first date shares are held by or for the benefit of an employee and after which there is no material risk that beneficial ownership may change. Accordingly, s CE 7B(1)(a) envisages that shares may be "held by of for the benefit of an employee" while there is a risk the employee may forfeit the shares or be required to transfer them to someone else. If there is a material risk the employee may forfeit the shares the "share scheme taxing date" will be deferred.

20. Section CE 7B provides examples to assist in its interpretation. The examples illustrate circumstances where shares are "held by or for the benefit of an employee" while there is a risk the employee may forfeit beneficial ownership of the shares. In Example 1, shares are held by a trustee on trust for Alice, i.e. for her benefit, while there is risk of her forfeiting the shares if she leaves her employment within 3 years. The risk is material and defers the "share scheme taxing date". In Example 2, the shares are held on trust for Bob while there is a risk of him forfeiting the shares if he is dismissed for serious misconduct. The risk is not material and so does not defer the "share scheme taxing date".

21. The Commentary on the Bill (Commentary) under which the current ESS provisions were introduced explains the new "share scheme taxing date" as "when there is no real risk that beneficial ownership of the shares will change, or that the shares will be required to be transferred". The Commentary describes this date as the date the employee "owns the shares in the same way as any other shareholder".

Share options

22. The Commentary and the *Tax Information Bulletin* also said no change was proposed to the tax treatment of "straightforward employee share options". They said the tax treatment of such options was already reflected in the principle that the taxing date is when the employee owns the shares in the same way as any other shareholder.

23. TCO's view was that an option is a right to buy a thing at a specified price within a specified time. The definitions imply the holder of an option or right to buy shares does not own the shares before exercising the option or right.

Application to the facts

24. Based on the evidence presented before it, TCO concluded that the date the Rights vested was the first date the Shares were held for the benefit of the Taxpayer because:

- The Rights granted to the Taxpayer under the ESS were rights to receive Shares, not options under which the Taxpayer had the right to buy the Shares and under which the Taxpayer had no beneficial ownership of the Shares until they did so. The Rights were not "straightforward employee share options" where the "share scheme taxing date" was the date the options were exercised.
- The Company held treasury shares to transfer to employees when they exercised their Rights under the ESS. On the date the Rights vested, the Taxpayer became entitled to receive Shares held by the Company, which the Company would transfer to them when they exercised their Rights. When the Rights vested, then, the Company held the Shares for the purposes of ultimately transferring the legal ownership of them to the Taxpayer, i.e. the Company held the Shares for the benefit of the Taxpayer.

25. The date the Rights vested was also the first date after which there was no material risk the Taxpayer's beneficial ownership of the Shares would change because:

- The risk of the Taxpayer forfeiting the Rights by failing to exercise them was immaterial. The Taxpayer did not have to pay anything for the Shares. Further, as the Shares were listed on a stock exchange there was a liquid market for the

Shares, which meant any tax impost could be funded. Based on these factors, the Taxpayer forfeiting the Rights by failing to exercise them was highly unlikely. Consistently with this, the Company recognised an increase in net equity at the end of vesting periods for Rights granted under the ESS indicating it too considered employees forfeiting Rights by failing to exercise them was highly unlikely.

- The risk of the Taxpayer being dismissed or a change in their role was also immaterial. Further, if the Taxpayer had resigned after the date the Rights vested, i.e. when they beneficially owned the Shares, it seems highly likely they would have first exercised the Rights.
- Although the Shares had to have reached a specified minimum value before the Taxpayer could exercise the Rights, the Shares exceeded the required minimum value at all relevant times and neither CCS nor the Taxpayer suggested this requirement posed a material risk the Taxpayer's beneficial ownership of the Shares could change.

Conclusion

26. The "share scheme taxing date" for the Shares was when the Rights vested. This was June 2020 and June 2021. These were the first dates the Shares were held for the benefit of the Taxpayer and after which there was no material risk their beneficial ownership of the Shares would change.