Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > PRIVATE RULING

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKATAUNGA TŪMATAITI

Share option cancellation

Decision date | Rā o te Whakatau: 23 June 2026

Issue date | Rā Tuku: 9 November 2026

TDS 26/19

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This document is a summary of the original technical decision so it may not contain all the facts or assumptions relevant to that decision.

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Subjects | Kaupapa

This item summarises a private ruling that considered whether a payment made in consideration for the cancellation of a share option under a share scheme is deductible expenditure.

Taxation laws | Ture tāke

All legislative references are to the Income Tax Act 2007.

Summary of facts | Whakarāpopoto o Meka

1. The Applicant is a company that established a share scheme in which it granted the option to buy shares in the Applicant to certain employees, contractors and directors (collectively referred to as participants).
2. After selling its business assets, the Applicant cancelled the share options that had not vested and were not previously exercised by the participants.
3. The Applicant made cancellation payments to the participants, which it calculated based on the value of the share option.
4. The asset sale agreement did not require the Applicant to cancel the options or make the cancellation payments.

Issues | Take

5. The main issues that the Tax Counsel Office (TCO) considered in this ruling were whether:
    - the Applicant has expenditure or loss under s DV 27(6) for the cancellation payments it made to the participants; and
    - the cancellation payments are deductible to the Applicant under s DA 1 and the capital limitation in s DA 2(1) applies.

Decisions | Whakatau

6. TCO decided that:

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- the Applicant had expenditure or loss under s DV 27(6) for the cancellation payments it made to the participants who were "employees" as defined in s YA 1; and
- the cancellation payments are deductible to the Applicant under s DA 1(1). Further, the capital limitation in s DA 2(1) did not apply to those payments.

7. TCO made this ruling subject to the following conditions:
   - The Applicant made the cancellation payments in recognition of current and past services.
   - The Applicant did not grant the share options to reward participants for effecting or facilitating the asset sale.
   - Any involvement of senior management participants in the asset sale was merely incidental to their existing roles.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Expenditure or loss under s DV 27(6)

8. Section DV 27 governs what deductions persons who are party to an employee share scheme (ESS) may take in respect of the ESS. Section CE 7 defines an ESS. Broadly, an ESS is an arrangement with a purpose or effect of issuing or transferring shares in a company:
   - to a person who will be, is or has been an employee or shareholder-employee (ie, persons described in s CE 7(a)(i) and (ii)) of that company or another company in the same group), or to an associate of such a person (ie, a person described in s CE 7(a)(iii)); and
   - that is connected to the employee's or shareholder-employee's employment or service.

9. Section DV 27(6) applies when a person is the employing or contracting company for an ESS beneficiary described in s CE 7(a)(i) or (ii). Under s DV 27(6), the employer is treated as having an amount of expenditure or loss determined under the formula in s DV 27(7).

10. The Applicant's share scheme is an ESS under s CE 7, and s DV 27(6) therefore applies, but only to the extent that the relevant participant is an "employee". The definition of "employee" in s YA 1 includes a person who receives or is entitled to receive a PAYE income payment.

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11. To the extent that the participants were employees as defined in s YA 1, they were ESS beneficiaries as described in s CE 7(a)(i) or (ii) and the Applicant was the employing or contracting company for those beneficiaries. For this reason, s DV 27(6) applied to deem the Applicant to have an amount of expenditure or loss for cancellation payments made to participants that were employees.

12. Not all the participants were employees of the Applicant – for instance, independent contractors were able to participate in the share scheme. Section DV 27(6) does not apply to cancellation payments made to non-employees. Accordingly, the ruling on this issue was appropriately limited to participants who were "employees" as defined in s YA 1.

13. TCO concluded that the Applicant had expenditure or loss under s DV 27(6) in respect of the cancellation payments made to the participants who were "employees" as defined in s YA 1.

Issue 2 | Take tuarua: Deduction under s DA 1 and general limitation in s DA 2

14. As the expenditure or loss is a cancellation payment (as opposed to the issue of shares), it is clear the Applicant has "expenditure or loss" for the cancellation payments to the participants, regardless of whether the expenditure or loss arises under s DV 27(6). In other words, while the Applicant has expenditure or loss under s DV 27(6) for cancellation payments made to employees (ie, under the ESS rules), it also has expenditure or loss under ordinary principles for cancellation payments made to non-employees (ie, outside of the ESS rules). Accordingly, regardless of whether s DV 27(6) applies, as the Applicant made cash cancellation payments, it incurred expenditure or loss to which s DA 1 can apply.

15. To be deductible, the expenditure or loss (whether it arises under s DV 27(6) or not) must satisfy the general permission in s DA 1 and be incurred in deriving assessable income, or in the course of carrying on a business for the purpose of deriving assessable income (subject to the general limitations).

16. The courts have held that a deduction is available if the expense has a sufficient nexus to the taxpayer's income-earning activities. To establish whether this nexus exists, it is necessary to focus on the relationship between the advantage gained or sought to be

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gained by the expense and the income-earning process, which in turn requires a focus on the true character of the payment made.[1]

17. Even if expenditure satisfies s DA 1(1), it is denied to the extent that a general limitation in s DA 2 applies. In the context of the share scheme, the capital limitation that denies a deduction to the extent the expenditure or loss is of a capital nature is relevant. In determining whether expenditure is capital or revenue, the courts have emphasised the distinction between the cost of creating or enlarging a profit-yielding structure and the cost of earning income.[2]

18. Cases that involved employee-related payments made in the context of a business sale or cessation have reached different outcomes depending on the character of the expenditure. In *Clough*,[3] the court found that cancellation payments under an ESS were closely connected with a takeover and were characterised by reference to that transaction. In contrast, *Cosmotron*[4] and *Foxwood*[5] found that payments triggered by the sale or closure of a business could still be deductible where they arose from employment obligations that had been incurred in the ordinary course of running the business. These cases show that a payment can still be revenue in nature even if it becomes payable because of a capital event.

19. TCO considered that, in this case, the Applicant made the cancellation payments to discharge the obligations it owed to participants under the share scheme rather than to dispose of its business assets. The Applicant had established the share scheme to reward and recognise the normal employment duties and contractor services. The Applicant made cancellation payments under that arrangement and calculated them by reference to the participants' option entitlements. Importantly, the asset sale agreement did not require the Applicant to cancel the options or make the cancellation payments.

20. Accordingly, the expenditure had the requisite nexus with the carrying on of the Applicant's business and was revenue rather than capital in nature.

21. TCO concluded that, subject to conditions that the cancellation payments were made in recognition of current and past services, the Applicant had not granted the share options to reward participants for effecting or facilitating the asset sale, and that any

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[1] *CIR v Banks* (1978) 3 NZTC 61,236; *Buckley & Young Limited v CIR* (1978) 3 NZTC 61,271.

[2] *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 (HCA) at 647 and 648; *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948.

[3] *Clough v FCT (No 2)* 2021 ATC 24,801.

[4] *CIR (Hong Kong) v Cosmotron Manufacturing Co Ltd* [1997] STC 1,134.

[5] *FCT v Foxwood (Tolga) Pty Ltd* (1981) 35 ALR 1.

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involvement of senior management participants in the asset sale was merely incidental to their existing roles, the cancellation payments were deductible to the Applicant under s DA 1(1) and the capital limitation in s DA 2(1) did not apply to those payments.

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