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Tax Policy
Inland Revenue Department

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Tēnā koutou,

Taxation of employee share schemes: start-up companies

1. Introduction

- 1.1. The New Zealand Law Society Te Kāhui Ture o Aotearoa (**Law Society**) welcomes the opportunity to comment on Inland Revenue's "Taxation of employee share schemes: startup companies" issues paper (**Issues Paper**).
- 1.2. This submission has been prepared with feedback from the Law Society's Tax Law Committee. It is structured as follows:
 - Our view of the key issues faced by startup companies and why reform of the employee share scheme (**ESS**) rules is necessary;
 - Discussion of the deferral regime proposed and why cashing out the ESS deduction for loss-making companies would be another viable option;
 - Discussion of what the appropriate scope of a deferral regime should be;
 - Discussion of why taxpayers should be able to elect into a deferral regime and how they can do so;
 - Discussion of why we agree with the taxing point events identified in the Issues Paper and recommend a longer "sunset period";
 - Discussion of why the corresponding employer deduction should also be deferred;
 - Discussion of the administrative and compliance aspects of a deferral regime; and
 - Discussion of the possible interaction between a deferral regime and the Research and Development (R&D) Loss Cash-out rules.

2. Valuation and liquidity issues for startup companies and their employees

- 2.1. We commend Inland Revenue for recognising that the current timing rules of Employee Share Schemes (ESS) pose significant challenges to the start-up sector. We support the introduction of a deferral regime for the reasons set out below, which align with the concerns that the Issues Paper identifies.

- 2.2. In our view, the main issue for start-up companies is the possibility of a “dry” tax liability arising for employees under the operation of the current ESS rules. This can be the case because the share scheme taxing date does not coincide with a company liquidity event (e.g., sale of shares or an IPO). This leaves the employee with a tax liability on income that they have not actually received in cash. Since startup companies are also often cash constrained, employers are also often unable to help fund the employee’s tax liability through the payment of additional bonuses.
- 2.3. We also agree with the Issues Paper that there are valuation issues for start-up companies which are often small, in a high-growth phase and unlisted. Without an established operating history, reliable cash flows, or significant tangible assets, valuation becomes uncertain and can be an expensive process. In some cases, this valuation issue is mitigated for startup companies which regularly engage in multiple series of capital raising, but in our experience, this is not the case for most startups.
- 2.4. Finally, we also agree that the Foreign Investment Fund (**FIF**) regime gives rise to another liquidity issue where the shares are not in a NZ resident company. Once the employee is the owner of the shares for tax purposes, the employee may be subject to tax on deemed income arising under the FIF regime. This adds another layer of tax complexity and the potential for further “dry” tax liabilities to arise for an employee holding shares in a foreign ESS.
- 2.5. Because of the issues above, in our experience, industry practice has been to offer long-dated options to delay the taxing date to a date coinciding with some liquidity event. This aligns with Inland Revenue’s experience, as detailed in the Issues Paper. Employees may feel forced into accepting options rather than acquiring shares earlier due to the risk of “dry” tax liability. While options allow employees to defer their tax obligations, this approach comes at a cost. The entire gain is taxed at the time of exercise, potentially resulting in a higher overall tax liability than if employees had been able to acquire shares earlier. Although the ultimate tax outcome may be similar, we agree that option holders may not have the same rights and sense of ownership as shareholders.
- 2.6. We agree with the Issues Paper that allowing for deferred taxation until the date of a liquidity event (i.e., a deferral regime) would address the issues above.
- 2.7. Further, we agree with the Issues Paper that there is a potential cost associated with deferring the taxing point. Effectively, employees will be taxable on any gains on the shares until the deferral taxing point occurs. This is a “cost” because, in most cases, any increase in the value of the shares between the usual (non-deferred) taxing point and the deferred taxing point would otherwise be a tax-free capital gain. However, we consider the risk of a “dry” tax liability is a more pressing issue for startup companies, as it is more likely that a liquidity event will occur in a later period. This outcome also aligns with the tax outcome for an employee who issued long-dated options and so this potentially higher tax cost is already a feature of many ESS issued by startup companies.

3. Deferral regime and other options for supporting start-ups

- 3.1. Given the issues outlined above, we endorse the deferral regime described in Chapter 3 of the Issues Paper. Further below, we outline submissions on the design of such a deferral regime.

- 3.2. However, and unlike the Issues Paper, we submit that the Commissioner should reconsider the option of cashing out the ESS deduction for loss-making companies as an alternative to the deferral regime. Section DB 27 of the Income Tax Act 2007 allows profit-making companies a deemed deduction for ESS income, which many use to help employees cover their tax liabilities. This is achieved through using the tax effected value of the tax deduction to fund an additional bonus to employees to help fund the tax liability arising on receipt of ESS income. We believe the ability to achieve this should also be available to loss-making companies and as such believe cash-out option should be considered. The cash-out option could be limited (for example) to where the benefit of the deduction is used to fund payments to employees. This could present a simpler option than introducing a complex new deferral regime.
- 3.3. Finally, we agree with the Issues Paper that a non-assessable, non-deductible approach should not be implemented. Given the concessional nature of this tax treatment compared to how other forms of remuneration are taxed, we agree with rejecting its extension beyond the scope of widely offered schemes.

4. Scope of Deferral Regime

Do you agree with the thresholds for defining a start-up company being based on the three categories used in the Australian rules (i.e., size, age and whether it is a listed company)?

- 4.1. We agree with the Issues Paper that the proposed deferral regime should be limited to “start-up companies”. For ease, New Zealand should follow the Australian approach in defining which companies are considered a startup company.
- 4.2. We submit that a startup company should be defined as a company that is:
- a) An unlisted New Zealand company;
 - b) Less than 10 years old; and
 - c) With annual turnover of less than NZD50 million.
- 4.3. This would align the New Zealand test with the Australian test. While we note that the New Zealand economy is smaller than the Australian economy, many startup companies (particularly startups involved in the technology sector) operate globally, both in terms of their customer base and in terms of attracting talented employees. In our view, the ability to benefit from ESS deferral should therefore be benchmarked against Australia.
- 4.4. In supporting the three tests above, we believe that the “cliff face” concern expressed in the Issues Paper (which might provide an incentive for a company to stay below the annual turnover threshold in order to be eligible for the deferral method) is unfounded. In our view, revenue generation is critical to any start-up company as it is revenue which typically drives their valuation and their ability to raise additional capital. It seems unlikely that revenues might be artificially depressed just to fall within the ESS deferral rules.
- 4.5. With respect to the revenue threshold, if the lower NZD15 million is to be considered to be the level at which a New Zealand company could be said to have left the start-up category , we recommend that the New Zealand Inland Revenue:
- a) Expound on how this threshold was arrived at; and

- b) Provide clear guidance on how and when this revenue threshold should be determined.

4.6. Finally, we agree with the Issues Paper that ceasing to qualify as a startup company should not affect shares already subject to the deferral regime and should simply prevent the company from issuing further shares subject to the regime.¹

If a threshold for the relative or absolute value of tangible assets were introduced what would be an appropriate threshold?

4.7. We submit that no threshold for the relative or absolute value of tangible assets should be introduced. This is because startup companies, which are usually technology companies, do not typically have significant amounts of tangible assets in their inventory. We therefore consider the Australian test above sufficient in defining what a “startup company” is.

If certain industries were to be excluded from this proposal, which industries would it be and why?

4.8. We submit there should be no industry carve outs for a deferral method. This is because delineating between industries may be an onerous and unnecessary process, especially now that technology is blurring the lines between industry types, and a group of companies may be involved in different types of industries. In other words, it would make it difficult to determine whether a start-up company may fall out of the deferral regime based on its assigned industry type.

What other thresholds or indicators might be appropriate (including whether or not the company has paid a dividend)?

4.9. We understand this was covered in the 2017 Issues Paper, where it suggested that another way to define a startup company is one that has not paid a dividend. The rationale behind this is that a dividend is an indicator of available cash, and the company is easily valued.²

4.10. However, we submit that liquidity and valuation issues are already addressed in the proposed definition of startup company above, and introducing another indicator such as this would be unnecessary and add an additional compliance burden. Although we believe it is more likely for a startup company to retain profits rather than distribute them, using a dividend payment as an indicator may result in dividend policies being set up whereby no dividends are paid at all so as not to lose the tax concession available for startup companies. This could result in tax policy artificially dictating a company’s profit distribution policy, which is not a desirable outcome.

5. Deferral Measure – Elections

Should any deferral regime for startup companies be elective or mandatory?

5.1. We submit that the deferral regime should be elective, allowing a startup company to choose what tax treatment is the most suitable for them. For example, a profitable startup company may be able to use the tax-effected value of the company deduction arising under section DV 27 to fund a bonus to employees to help them fund their tax liability arising under an ESS scheme, thereby eliminating the need to defer the tax liability.

¹ See paragraph 4.10 of the Issues Paper.

² See paragraph 4.10 of the 2017 Issues Paper.

If elective, on what basis (scheme-by-scheme or employee-by-employee)?

5.2. We submit that the deferral regime should apply on a scheme-by-scheme basis. Again, this would allow startup companies to choose the most appropriate tax treatment for their scheme, based on their facts and circumstances at the time, which may change over time and over the course of potentially issuing multiple schemes as their employee base expands.

Should the choice to defer payment of the tax be available to the employer or the employee?

5.3. We submit that:

- a) Employers should be able to offer schemes that allow for deferral, but should not be compelled to. In other words, the deferral rules should not automatically apply.
- b) If an employer offers a scheme that allows for deferral, individual employees can be provided the choice (at the time when they enter into the scheme) as to whether or not they will be subject to deferral. Allowing employees this choice will cater for both employees who may face challenges in funding a “dry” tax liability, while also allowing a choice for employees who wish to trigger an earlier share scheme taxing date (i.e. a share scheme taxing date that would arise under ordinary ESS rules) and thereby potentially increase the amount of tax-free capital gain they could derive from ownership of shares under the scheme.

What other design issues need to be considered for a deferral regime?

5.4. To provide certainty and encourage compliance, the elections should be made up-front or be included as a part of the terms of the ESS.

6. Deferred Taxing Point

Do we agree with each of the tax point events identified?

6.1. We agree with the tax point events identified in the Issues Paper, being:

- a) When shares are sold;
- b) An initial public offering (IPO) of the shares on a recognised exchange;
- c) The employee ceasing employment with the employer or ceasing to be a New Zealand tax resident;
- d) Cancellation of the shares, including on the company being struck off;
- e) Winding up of the company; or
- f) A “sunset date” where recognition of income cannot be delayed after this point.

Are there examples of any practical difficulties with any of these events?

6.2. First, with respect to the taxing point events above, we make the following further submissions:

- a) Regarding the valuation of shares when an IPO triggers a taxing point event, we recommend adopting a more expansive version of the Australian approach. In Australia, shares can be valued based on their market price if sold within 30 days of the deferred taxing point, rather than the IPO listing price. We suggest a similar

method for New Zealand, but instead of a time limit, shares should be valued on the first day they are legally allowed to be sold from the deferred taxing point. This would address the issue of employees being unable to sell shares on the IPO date (or within 30 days of IPO date) and provide a fairer valuation for tax purposes if the share value decreases significantly between the IPO date and the sale date. We are aware of circumstances where this exact fact pattern has occurred. If this approach is adopted, the New Zealand Inland Revenue should offer clear guidance on how this rule would interact with ESS reporting.

- b) The onus on determining whether an employee ceases to be an employee of the company or a New Zealand tax resident should be borne by the employer for simplicity.

- 6.3. Second, the Issues Paper is also seeking submissions on how a deferral regime should apply when an employee owns shares that are subject to the deferred taxing rule and other shares of the same class.³ Options proposed are that the shares sold could be deemed to be the shares subject to the deferred taxing point or should follow section ED 1(5), which provides an option between FIFO or a weighted average cost method. We submit that an approach similar to section ED 1(5) should be followed to maintain consistency with our existing tax rules.
- 6.4. Finally, with respect to takeovers and restructures, we agree with the Issues Paper that our existing rollover relief provisions are sufficient to deal with such events. Broadly, if a person's ESS rights are cancelled and replaced with rights in a different scheme, the value of the replacement rights is not included as income. Additionally, the benefit provided by the replacement scheme should also be subject to the proposed deferral scheme.

Are there other events that should trigger a tax liability?

- 6.5. In our view, the taxing point above are comprehensive enough to allow deferred recognition of income for start up companies.

Should there be a sunset period and, if so, how long should it be?

- 6.6. We suggest there should be a sunset period as a form of integrity measure. However, we submit that a 15-year sunset period is more appropriate compared to the 7-year sunset period proposed in the Issues Paper. This will make our deferral regime more appealing for start-up companies, and would reflect Australia's move from their 7-year sunset period to a 15-year period.

7. Employer Deductions

Do you agree that employer deductions should also be deferred in relations to the shares offered under a deferred ESS?

- 7.1. We agree with the Issues Paper that employer deductions should also be deferred. This would ensure there is no mismatch in timing between revenue derived by the employee and deductions taken by the employer. The ESS regime aims to align with how other forms of

³ See paragraph 6.9 of Issues Paper.

remuneration are taxed, and ensuring that deductions are allowed only when income has been derived by the employee would be consistent with this design feature of the ESS rules.

What practical difficulties might there be for employers in identifying the deferred date, for example, if it is triggered by an employee selling shares or becoming non-resident?

- 7.2. As discussed above, we submit that the employer should bear the burden of identifying whether an employee or former employee has sold their shares or has become a non-resident. Employers would have to do this anyway in determining when their corporate income tax deduction arises and how much the deduction would be.

8. Administration and Compliance

What kind of reporting and record-keeping requirements would be necessary and appropriate to ensure that income and deductions from tax deferred share schemes are appropriately returned, and tax is paid?

- 8.1. We submit that the reporting and record keeping requirements should be consistent with our current ESS reporting rules. This would require amending section 23K of the Tax Administration Act 1994 to clarify that “deferral date” for startup companies is the date of a liquidity event.

9. Research and Development Loss Cash-out

- 9.1. We agree with paragraph 9.14 of the Issues Paper that ESS costs, if they meet the other requirements, should be explicitly included in total labour expenditure and total R&D labour expenditure for the purposes of the R&D loss cash-out rules. This inclusion will enable companies eligible for the R&D loss cash-out to receive a tax refund under the scheme, which could be used to cover a significant portion of the employee’s tax liability on ESS benefits.

Nāku noa, nā



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