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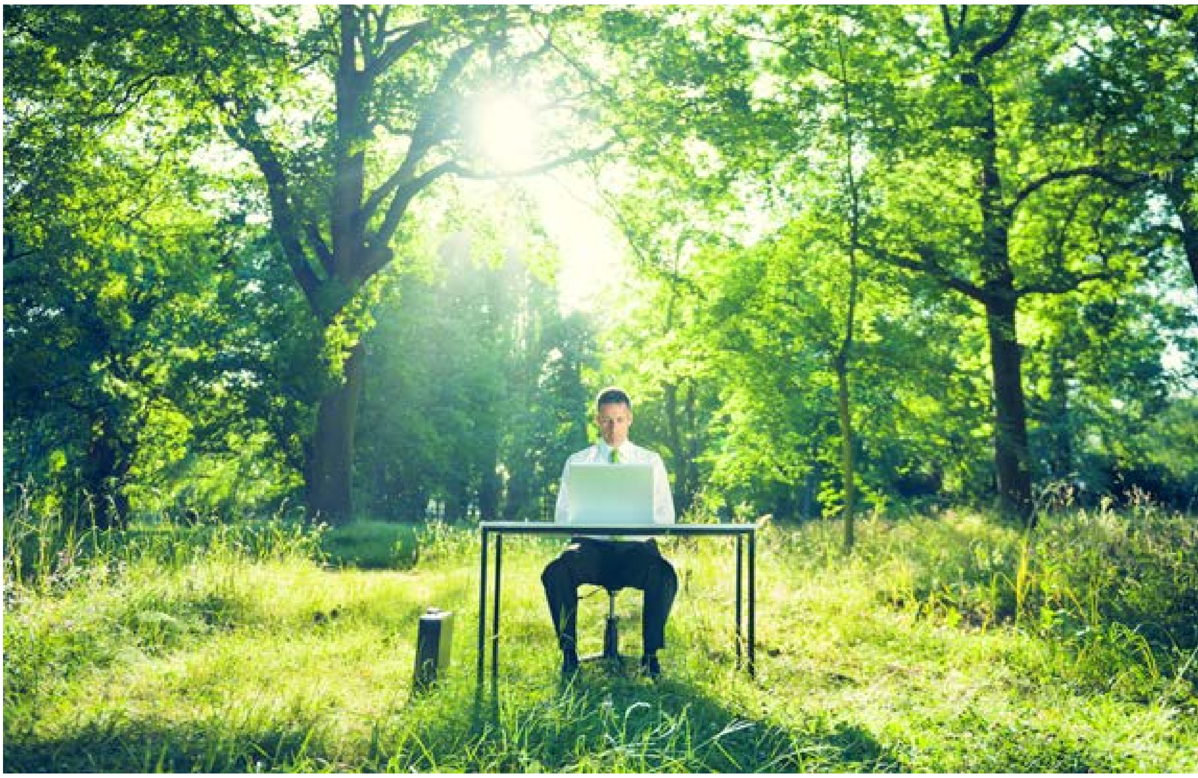

Revenue Alert issued on certain employee share purchase agreements

Inland Revenue has issued a Revenue Alert RA 15/01 on Employee Share Purchase Agreements, specifically arrangements which have the effect of reducing the taxable benefit to employees under a share purchase agreement. The purpose of Inland Revenue issuing a Revenue Alert (RA) is to provide information about a "significant and/or emerging tax planning issue" that is of concern to it. An RA outlines the Inland Revenue's current view of how the law should be applied to particular arrangements. In our view, this RA is likely to be viewed as contentious and raises a number of issues/questions.

By way of background, the current law taxes the difference between the amount an employee paid to purchase the shares, either directly or after the exercise of an option, and the market value of the shares at acquisition. Employees are currently responsible for paying any tax on any benefit received in their own tax return.

There are a myriad of different employee share schemes and features for structuring such agreements. Different tax rules apply depending upon whether the shares are subject to an option to purchase or have been acquired at the outset (with or without any constraints or conditions).

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Inland Revenue has issued this RA because it has some concerns about some schemes with certain features which could be seen as altering the benefit that is taxed. Specifically there is concern about arrangements which seek to accelerate the point in time at which the employee can be said to have acquired the shares, in this way eliminating the tax liability on any subsequent increase in value of the shares. According to Inland Revenue, this usually involves treating what are rights or options, in commercial and economic reality, as acquisitions. The RA contains the following example below to highlight one area of concern regarding in-substance options:

Example 1 – An in-substance option

Corp Limited enters into a share purchase agreement with its employee, Mr Wright. Under the share purchase agreement Mr Wright acquires 100 shares in Corp Limited that are held for his benefit by Hold Trust (this occurs in Year 1). Hold Trust is a trust established for the benefit of employees of Corp Limited. Mr Wright does not receive any voting, dividend or other participation rights in the shares while they are held by Hold Trust; these rights are instead held on trust for Corp Limited. Subject to certain performance criteria being satisfied, the shares will vest in Mr Wright after 3 years. However, Mr Wright has a right to reject the transfer of the shares on vesting. The shares are acquired for $2 per share (i.e. $200), which is funded by way of a loan from Corp Limited to Mr Wright. If the performance criteria are not satisfied, or Mr Wright exercises his right to reject the transfer of shares on vesting, Mr Wright must transfer his beneficial ownership in the shares to Corp Limited in full satisfaction of the loan amount outstanding. If the shares vest and are transferred to Mr Wright, he must repay the loan in cash.

The shares have a value of $2 per share when acquired, so Mr Wright does not return any income. This is on the basis he paid market value for the shares and therefore there is no benefit to him under the share purchase agreement.

Three years later the shares vest and are transferred to Mr Wright. At this time the shares have a value of $4 per share. The shares are sold for $400 by Mr Wright and the $200 loan from Corp Limited (for the purchase of the shares) is repaid, resulting in a gain of $200 to Mr Wright. Mr Wright does not return this $200 gain as income on the basis that the shares were acquired from Corp Limited when they were legally acquired by Hold Trust (for Mr Wright's benefit) and had a value of $2 per share. Thus, Mr Wright had already acquired the shares when the trust subsequently transferred legal title in the shares to him, when the shares had a value of $4 per share. Accordingly, Mr Wright treats the $200 gain as a capital gain that accrued while he owned the shares.

In this example, while the shares are acquired by Hold Trust in Year 1 for the benefit of Mr Wright, Mr Wright does not possess the rights normally associated with ownership of shares until legal ownership has passed in Year 3. In addition, Mr Wright has the choice as to whether or not to retain ownership of the shares or reject the transfer of shares on vesting. The increase in value of the shares from when they were "purportedly" acquired in Year 1 to when they legally vest in Year 3 is not assessable income to the employee. The facts, features and attributes may give the appearance of share ownership by Mr Wright in Year 1, however Inland Revenue considers that in economic and commercial reality, this is an option.

According to Inland Revenue, the real economic and commercial acquisition of the share occurs in Year 3 when legal title passes. The RA states that Parliament intended that the rules tax the difference between the value of the shares acquired under an option at the time the option is exercised and the shares are acquired. Inland Revenue therefore considers this example to be a tax avoidance arrangement. Accordingly, it can reconstruct the arrangement so that the $200 gain in value of the shares is treated as assessable income to Mr Wright.

Of concern is that the RA doesn't stop at saying it is concerned with Example 1. In its analysis of the arrangement it goes on to state (emphasis added):

"There are many different employee share purchase scheme arrangements. Some arrangements will exhibit some, but not all, of the features found in Example 1. For example, an arrangement may allow the employee to exercise the rights associated with shares (e.g. voting and dividend) pending vesting of the shares and transfer of legal title to the employee. Alternatively, an arrangement may not allow the employee an option as to whether the shares vest at the end of a vesting period. ***Such arrangements may still be tax avoidance.*** *Each case will need to be considered on its own facts, and the various attributes weighed against Parliament's intention for the employee share purchase scheme provisions."*

The other area of concern is arrangements involving a reclassification of shares. The following example right is provided to illustrate this issue:

Example 2 – Reclassification of shares

Liability Limited enters into a share purchase agreement with its employee, Mrs Jones, for her to purchase 100 Class B shares that are non-transferrable and have no voting or dividend rights in Liability Limited. The only right the Class B shares have is to reclassify to ordinary shares in two years if certain qualifying criteria (e.g. increased sales of Liability Limited) are met. The Class B shares were valued by the Company at $1 per share and Mrs Jones paid $100 to purchase them, although at the time the market value of ordinary shares in Liability Limited was much higher.

Mrs Jones does not return any income on the acquisition of the Class B shares on the basis she paid market value for their purchase and therefore there is no benefit to her under the share purchase agreement (i.e. she paid $100 to buy $100 worth of Class B shares).

The criteria for reclassification is met two years later and the 100 Class B shares held by Mrs Jones are reclassified as ordinary shares of Liability Limited, which have a market value of $9 per share at that time.

Under the arrangement Mrs Jones has received ordinary shares worth $900 (100 ordinary shares with a value of $9 per share) and has only had to pay $100 (paid $1 per share for 100 Class B shares). Despite an $800 gain, Mrs Jones returns no income. This is on the basis she purchased the shares (i.e. the Class B shares) at their value and that the reclassification of the Class B shares to ordinary shares is not taxable.

In this example, Inland Revenue considers that the real benefit is derived when the Class B shares reclassify to ordinary shares. However, instead what is valued is a highly contingent right to those shares at a significantly reduced value given the uncertainty that the qualifying criteria will be met. Inland Revenue considers that this example, when viewed in a commercially and economically realistic way, does not make use of the legislation that is consistent with Parliament's intention and is therefore a tax avoidance arrangement. Inland Revenue would seek to tax the employee on the real benefit of $800.

Inland Revenue views arrangements in the nature of Example 1 and 2 as tax avoidance arrangements and subject to reconstruction. It recommends that those affected discuss this RA with their tax advisor or Inland Revenue and consider making a voluntary disclosure.

Inland Revenue may initially approach employers who have implemented employee share schemes for more details about the schemes and, if there are concerns, perhaps request details of employees who have participated.

Our thoughts

This RA is likely to create considerable uncertainty as it is not exactly clear just where Inland Revenue are drawing the line. It is not clear what combination of features (or lack of) might be determinative for a particular arrangement. As noted above, there are a multiple of varying forms with different features, and the RA says that other schemes may constitute tax avoidance subject to weighing up all the different attributes of the scheme. The RA attempts to assist taxpayers by providing a number of factors to consider at paragraph 7, but falls short of providing any meaningful guidance:

Arrangements of this sort vary a good deal, and we will look at a number of criteria in combination when deciding whether to investigate a case. These include, for example:

a) The level of control the employee has over the shares while they are part of the share purchase agreement. (It is accepted that restrictive covenants over disposition of the shares are a very common element of employee share plans.)

b) Whether during any restrictive covenant period the employee can exercise rights attaching to the shares (such as voting rights), and whether the benefit of dividends, if any, is passed to the employee in commercial and economic reality.

c) Whether the employee has any direct or indirect rights to dispose of the shares in a way that negates the original acquisition or otherwise means the employee is not exposed to real commercial risk on ownership of the shares.

d) Whether the nature of the arrangements put in place (which often include the shares being held by trustees for an interim period) means that benefits attaching to the shares during the restrictive period are enjoyed more by the employer (or someone else) than the employee.

e) Whether, as a matter of commercial and economic reality, the arrangement is more likely to be categorised as an option rather than a full acquisition of the shares.

Each situation will require careful consideration.

Inland Revenue have previously issued favourable binding rulings on arrangements that are very similar to Example 1, however it is now clear that they have a different view on these arrangements. Inland Revenue has a duty of care to manage the integrity of the tax system and in our view there are strong grounds for a prospective approach to be adopted in relation to the enforcement of Inland Revenue's current interpretation.

The RA does state that, if possible, Inland Revenue will have discussions with the company and its tax advisors before formally commencing an investigation into a share scheme, putting them on notice and providing an intermediate step before employees are contacted. But this will be of little comfort to employees who have participated in share schemes because it is the employees that are responsible for paying any tax on the benefit derived, those at most risk are employees who have already taken a tax position in their tax return that any benefit derived is a capital gain. Worst case, Inland Revenue could reconstruct past positions taken and impose interest and penalties. There is no guidance in this RA on how far Inland Revenue intends to go back to assess earlier periods.

The RA notes that those affected should consider whether to make a voluntary disclosure (which would have the effect of reducing any penalties). We see a number of issues with this. In a lot of cases employees will have moved on to new employers and employers may not be in a position to notify former employees of Inland Revenue's enquiries. We recommend employees who have participated in employee share schemes make contact with their former employers to ensure that they are notified of any Inland Revenue concerns and can consider whether they wish to make a voluntary disclosure.

There is no indication whether Inland Revenue will further reduce any shortfall penalties to encourage taxpayers to come forward. For example, it could be useful if Inland Revenue were to take a similar approach to the Penny & Hooper position a few years back and provide an amnesty or window within which to make a voluntary disclosure (preferably with assurance of no penalties) to encourage this. That situation was similar in a number of respects and also had the backing of a Supreme Court decision.

Way forward

Ultimately the RA puts everyone in an uncomfortable position until such time as Inland Revenue has questioned and "blessed" an employer's scheme. In our experience, Inland Revenue are very good at asking questions but often do not close the loop and advise taxpayers of the outcome of their review. Also when tax avoidance is in the mix, in our experience it can be difficult to have anyone at Inland Revenue commit to either a binding or non-binding view. Given the release of this RA, the onus is on Inland Revenue to provide employers with the certainty that isn't received from this RA.

There will be some employees that are currently participating in a scheme that may have similar features as described, but who have not yet taken a tax position in a tax return because a benefit has not yet arisen. In this case there is nothing to disclose as yet, but they will need to consider what tax position they take if they receive a benefit of the type as described in the two examples outlined above. Simply continuing to treat such benefits as non-taxable may expose a taxpayer to additional penalties if the treatment of the scheme is successfully challenged.

Another factor to consider is that the Tax Policy Work Programme states that Inland Revenue is to undertake a review of employee share schemes. We understand that this work is underway and public consultation is expected to take place in early 2016. Until the policy position is known, we are now in a place where it is very difficult for an employer to develop and implement a new employee share scheme given the effort that can be involved in setting up these arrangements and the question marks over the resulting tax treatment. It is unfortunate that tax may be hindering commercial decision making.

The bottom line is that all employers with schemes in place and all employees participating in such schemes should seek tax advice on their specific circumstances and employers and employees (including former employees) will need to keep in contact over any Inland Revenue communication. For more information, please contact your usual Deloitte tax advisor.

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