Employee Share Schemes

An Employee Share Scheme (ESS) offers employees a chance to own an interest in your business. It's an arrangement to issue or transfer shares in a company or a group company (or the cash value) to a past, present or future employee or shareholder-employee. It may also extend to a director if they receive income from the company that is subject to PAYE (including schedular payments).

It's a benefit to the employee when shares are provided for free or below market value. Under these circumstances, the shares are subject to income tax as an employee share scheme benefit.

An ESS benefit is usually provided in shares. It can also be offered in securities, 'stapled securities' (where two or more securities are bound into one and they cannot be bought or sold separately), or options to acquire these. In some situations, the benefit may be paid in cash instead. In this case, the benefit is called a cash-settled ESS benefit.

Employers can offer a range of schemes to incentivise employees with an ownership stake in the company. They can choose to offer employees an option to acquire an interest in the business with:

- employee share purchase plans
- long-term incentive plans
- performance share rights plans
- employee share option plans
- restricted or performance stock units

And they can offer mechanisms for acquiring these interests such as:

- employees making full upfront payments for the shares
- salary sacrifice arrangements
- employer-provided loans
- employers providing shares or options linked to an employee's performance

How do I set one up?

Identify how you will value the shares to be offered. Depending on the valuation method, it may be possible for you to offer ESS interests below current market value, increasing the incentive for employee participation. Determining the market value is key, and Inland Revenue have set out their acceptable methods for valuing shares in companies that are not listed on the stock exchange (NZX):

- arm's length value determined by an independent, qualified valuer that conforms with commercially acceptable practice (that is, one that meets criteria under standards issued by Chartered Accountants Australia and New Zealand or equivalent)
- valuation involving the arm's length issue or sale of the same class of shares to a third party in the 6 months prior to this issue
- valuation that an appropriate person in the company prepares using a method incorporating requirements outlined in the Inland Revenue Commissioner's Statement 24/01

If the unlisted company is regarded as an 'unlisted start-up company', then adopting a valuation prepared by an appropriate person in the company will not be available where there has been a previous valuation determined by an independent qualified valuer, or a recent issue or sale of shares to a third party in the 6 months prior to this issue. An 'unlisted start-up company' will generally be a company:

- in the first stage of its operations
- initially financed and operated by founding shareholders or investors
- that has not paid any dividends
- having expenses tending to exceed revenues, and likely not yet producing a profit
- that has low net tangible assets, and a high research and development cost amount relative to the net tangible assets, and
- that does not yet have a stable market for its product or service

Tax implications for employers

In some situations, you must withhold tax from an employee share scheme (ESS) benefit and in others, you can choose whether to withhold tax. You must file employment information about the value of an ESS benefit provided to an employee, whether you withhold tax from the benefit or not.

If an ESS benefit is in shares, you can choose to withhold tax. If you do not withhold tax, then the employee pays the tax through the end-of-year tax process (and provisional tax if that applies). Let employees know they will have to pay any tax owing on ESS benefits at the end of the tax year.

If an ESS benefit is in cash, you must withhold tax.

Where tax is withheld on ESS benefits provided in cash and benefits provided with shares (where the employer has opted to deduct withholding tax), the withholding tax rate will be the 'extra pay' tax rate under the PAYE rules, taking into account student loan obligations, but not KiwiSaver and accident compensation corporation (ACC) deductions.

Employers can usually claim a deduction if they're providing ESS benefits.

Tax implications for employees

If you have not withheld tax on an ESS benefit (ie shares, a non-cash benefit) to an employee, the employee will pay tax on the benefit through their IR3 at the end of the year. Tax is imposed on the 'share scheme taxing date' which effectively means the date on the employee is treated as having earned the shares and holds them like any shareholder. This becomes relevant when considering options or deferred entitlements to shares under the various types of employee share schemes.

For example, if an employee has options through an ESS, employees can possibly benefit from tax advantages via the operation of:

- tax on the purchased option being deferred until the shares are sold
- on sale, if the holding period has been more than 3 years, an employee may be eligible for an income tax concession

Employee Share Loans

In some circumstances, you might make a low-interest loan to an employee to enable them to acquire shares in your company (or an associated company). Such loans are excluded from the definition of a fringe benefit but they must meet certain criteria, and you need to keep adequate records. While employers have discretion over the interest rate to charge for low-interest loans, Inland Revenue sets prescribed rates to normally determine the fringe benefit value of low-interest loans provided to employees for reasons other than under an employee share scheme. When you are working out your FBT liability, you need to use these rates.

However, as noted above, for loans made to employees under employee share schemes, there is a specific exclusion from FBT for low-interest loans provided under an employee share scheme.

Exempt schemes

Exempt schemes are schemes that require that shares be genuinely offered to most employees on equal terms and that limit the number of shares offered. If the scheme meets the criteria set out in section CW 26C of the Income Tax Act 2007, employees can receive shares in their employer company on a tax-free basis.

With exempt schemes, you can also make a no-interest loan to an employee for them to acquire shares in your company. With exempt schemes, the shares are exempt income to the employee. As the employer, you cannot claim a deduction for the cost of providing the shares (apart from setup and management costs). However, you are also not liable to pay FBT in these circumstances.

Keep in mind

Employee share schemes can benefit a company by providing an incentive to employees to make the company more valuable, giving them a vested interest in improving the company's results. Also, issuing shares in the company can be done with no immediate cash cost to the company.

This is a complex area from a financial and tax perspective. The tax rules have become more complex in recent years, and we expect more changes to emerge. Let us know if you are interested in establishing an ESS for your business. We can go through what's important to you, how you envision it working, and what the tax implications are for your business and your team.