Submission

New Zealand Private Equity and Venture Capital Association

Employee Share Scheme Issues Paper

June 2016

Background

The NZVCA is dedicated to improving private investment and increasing the openness to and availability of growth capital in the New Zealand market. Private capital is essential to the majority of New Zealand businesses, whether at the start-up phase or more mature.

We consider that a key part to the development of so many New Zealand businesses is the way in which founders, owners, key senior management and staff more generally have access to and can invest in such businesses, or be incentivised through equity ownership.

The primary engines of growth in developed economies involve innovation and its successful commercialisation. The Business Growth Agenda drives this by ensuring the Government stays focused on what matters to business, to encourage confidence and further investment.

New Zealand has, over recent years, endeavoured to simplify tax and regulation for business at the same time encouraging investment (including foreign investment) in innovation and productivity.

Confidence in financial markets, improved financial literacy and diversified savings for retirement are all goals that contribute to the business growth agenda.

Encouraging wider ownership of business enterprises and motivation of employees through employee share ownership contributes positively to innovation and productivity objectives.

Private equity ownership of New Zealand businesses is ten times listed equity. The regulatory and tax environment of private markets, especially early stage and growth companies, is critically important for the future of the New Zealand economy.

NZVCA supports a reform of the taxation of employee shares schemes. However, we are cautious of unintended consequences of regulatory changes that impact the broader private equity market including founders, growth investors and employee shareholders.

NZVCA encourages a broad view of regulatory reform within the context of the established business growth agenda.

Key Points

The NZVCA makes the following key submissions:

1. Restrictions attached to the holding of shares that relate to the ongoing employment of those employees, and which seek to provide wholly commercial protections to businesses and the shareholders themselves also, should not be seen as “conditional” arrangements as contemplated in the Issues Paper.
2. Where shares have been acquired at below market value or gifted, indefinite deferral of the taxing point is required for shares until an actual liquidity event arises, or is at least available (i.e. once shares have been listed).
3. The law should provide for a ‘rollover relief’ mechanism, whereby ‘proceeds’ reinvested into a new vehicle upon a change in majority ownership should not be taxed.

4. An elective regime should be considered, whereby shareholders can elect to have a valuation done and either pay that value for the shares or be taxed on that value in that year (i.e. dry income with no deferral), or defer any taxing event and have the full value taxed on exit/realisation.
5. A broadly applicable share scheme, of the nature of the DC 13 and DC 14 schemes, is an advantageous vehicle to have in order to encourage employees to participate as equity holders, and can have significant broader benefits to NZ's capital markets and long-term savings and investment goals.
6. We strongly refute that there are no externalities associated with the considerations in this Issues Paper. There is significant research that points to the macro-economic benefits gained from share plans and business alignment, including increased productivity, better financial literacy and improved savings and investment. Each of these are critical to NZ Inc.

We provide expanded submissions on these points below.

1. Conditional vs unconditional share arrangements

We strongly disagree with the general principle that employment related restrictions should be considered a factor that results in shares being seen as held on a "conditional" basis. Many privately owned businesses, speaking more broadly than private equity or venture capital invested businesses but to all privately owned businesses, would generally always seek to have some form of employment restriction as a condition commercially, including limiting employees' ability to transfer those shares. Those reasons may include ensuring that the company does not become widely held or held by those with mis-aligned objectives, providing opportunities for effective hostile takeovers, or even the signaling of performance issues or lack of confidence in the business to external stakeholders. The point is that such reasons can be many and varied, but each are wholly commercial.

We consider that detailed analysis and thought should be given to the differentiation of various holders of equity, and the factors that should be considered. We believe that this is critical in ensuring that tax is not a distorting factor in many appropriate shareholding arrangements, and that the introduction of any new law should not be fast-tracked to deliver to any deadline, but should undergo robust discussion, submissions and engagement over an extended period to ensure that all options and factors are given full and proper consideration, and ultimately that the best law from a policy and commercial perspective is developed.

Broad categories for differentiation, particularly in a private sense, may include:

1. Founder shareholders or pure equity (non-employee) shareholders;
2. Management / employees who hold equity outside of a 'true' share incentive plan (which may still include founder shareholders); and
3. Broader management / employees who hold equity through a 'true' share incentive plan.

For example, taking the second category above, where a senior executive buys shares in a company at Y0 with no loan (or a full recourse loan) and no down-side risk protection exists, but still with restrictions via a shareholders agreement (or similar) relating to the ability to sell those shares to anyone other than the company/existing shareholders and that upon leaving the company at Y4 that they must sell those shares back to the company/existing shareholders, such a condition should not be seen as making the shares held "conditional" for the purposes of the discussion document. They should still be considered fully "unconditional" shares, with the taxing point remaining at Y0.

This should still be the case where the shareholders agreement includes a pre-determined mechanism for the valuation and buy-back/purchase of such shares when an employee leaves the business or upon a sale. That mechanism could involve a formal valuation both at Y0 and Y4, or could include a more explicit calculation mechanism, as most relevant to that company/sector, tied to net assets, an EBITDA multiple, a revenue multiple or similar. The point being that that would be a mechanism considered by the parties at the time, and absent a flagrant choice to subvert a true and fair valuation (in which case avoidance considerations should be relevant in any event), should be respected. So when that employee, at Y4, makes a substantial gain (hopefully) against the price initially paid, that should still be respected as a tax free capital gain and not caught by any revised employee share plan rules.

If share arrangements that provide down-side protection are one of the main concerns of IRD Policy and Treasury, then it should be those precise factors that are legislated for; in a careful and restricted manner. With our current anti-avoidance provisions and the court's interpretation and application of those, including the application of the 'Parliamentary contemplation test', seeking to legislate against the other (non-employment related) factors and to also clearly spell out that the principle that Parliament was contemplating was to move the taxing point where protection from economic down-side risk was more than a merely incidental purpose or effect, would provide the appropriate level of protection to the tax base. If parties seek to then subvert the ultimate intention, anti-avoidance mechanisms should be the appropriate tool in dealing with those exceptional circumstances, not enforcing unnecessarily broad restrictions on completely legitimate arrangements, and hence creating tax distortions that are counter-productive to the broader business and macro-economic benefits.

2. Deferral of taxing point

As outlined, where shares have been acquired at below market value or gifted, indefinite deferral of the taxing point is required for shares until an actual liquidity event arises, or is at least available (i.e. once shares have been listed).

It can be many years until a liquidity event occurs for private companies, particularly start-ups. Using options with non- or long-dated option exercise dates is not commercially practical or attractive, so options do not solve the problem of being able to defer the taxing point. An alternative would be to allow deferral even upon the actual provision of shares (not options), such that a shareholder could elect to be taxed on a deferred basis.

We also note that if tax was payable at an earlier time, for example for gifted shares, particularly in relation to start-up ventures that more often than not fail, that those shareholders could end up paying tax on a worthless (or at least worth less) share, but still with no tax deduction where such shares are held on capital account (as they generally would be).

3. Rollover relief

Any taxing provisions introduced should include a 'rollover relief' mechanism, as there is in many jurisdictions that do operate a capital gains tax, such that exercising options or selling shares but being required (which is often the case) to reinvest some or all of such 'proceeds' into a new vehicle upon a change in majority ownership, should not be considered a true liquidity event at which point tax arises.

4. Election to tax at outset or liquidity event

We recommend that an elective regime should be considered, whereby shareholders can elect to have a valuation done and either pay that value for the shares or be taxed on that value in that year (i.e. dry income with no deferral) and then have it respected with capital gains upside, or defer any taxing event and have the full value taxed on exit/realisation.

Many start-up companies and/or their management will not have the cash resources to be able to pay any tax associated with 'dry income', but likewise some may. Given the examples 7 and 8 outlined in the Issues Paper and IRD Policy and Treasury's view that "tax at issue and deferred tax at sale are equivalent", we see no reason not to allow for the treatment to be elective.

We note that the example, however, is practically fraught, in that someone would generally be offered $100 of shares now and be left to pay the tax themselves, or if deferred be taxed on the whole amount. The outcome of that, assuming the shares increase in value 10 times, is actually:

Option 1 – receive $1,000, less the $33 paid day 1 = $967; vs

Option 2 – receive $1,000, less $330 in tax to pay = $670.

We also note that most countries have a formal valuation approval mechanism, and this should be considered, with the full restrictions and priority in ranking (i.e. preference vs ordinary) attaching to any such shares being considered in that valuation.

The whole approach to valuation of shares should be reconsidered more fully. More simplistic 'safe-harbour' tests should be considered for lower value / start-up businesses, while more significant valuations should be able to take account of all factors / restrictions attaching to shares.

5. Broad based, low administration share schemes

We reinforce the desirability of retaining provisions (such as ss DC 13 and DC 14), or to provide even simpler such arrangements, to facilitate broad-based employee share schemes with a minimum of resulting employee (and employer) tax compliance obligations.

Encouraging employees to participate as equity holders can have significant broader benefits to NZ's capital markets and long-term savings and investment goals, and such simple and low-value schemes likely provide a simple mechanism to do so.

We also note that we consider that the current thresholds for such schemes are unrealistic and outdated. We suggest a maximum annual value of shares provided of a much higher amount, for example.

6. Broader externalities and benefits derived from share ownership

We would welcome the opportunity to engage in this topic more fully, but do not seek to set out background economic and policy analysis and research references at this point due to the vast array of such material.