Taxation of complex employment remuneration

James Coleman

This month has seen a determination and number of exposure drafts released by Inland Revenue relating to the taxation of employee's remuneration. All these publications relate to reasonably complex remuneration situations. This article will look at Special Determination S33, Exposure Draft QB 15/X1 and Exposure Draft QB 15/X2.

Special Determination S33 deals with the application of the financial arrangement rules to a particular long-term incentive plan established for the senior executives of a New Zealand company. The company wished to establish an incentive plan for its senior executives so it proposed setting up an arrangement to do this.

As will be seen later, the arrangement interacted with the financial arrangement rules and clarity was required as to what proportions of the various considerations related to the extent of taxable income. Accordingly the company applied for a special determination under section 90AC(1)(h) of the Tax Administration Act 1994. The special determination relates to the application of the financial arrangement rules. There had been an earlier application for a private binding ruling, which was issued on 4 February 2015.

The proposed arrangement in respect of which the special determination was to relate involved incentivising senior executives through the increase in value of the company's shares, which they would be offered.

In terms of the detail of the proposal, it was intended that the company would make a loan to each of the senior executives considered worthy of participating in the scheme. The loan would be made to a trustee who in each case was acting as agent for the executive in question.

The trustees would acquire shares in the parent company. These acquisitions would be made on behalf of each participant and would be funded by the loans. The trustees would buy the shares either on the open market or by subscribing to shares in the parent company or by the parent company transferring shares from its unallocated shareholding for the benefit of each of the senior executives.

The trustees would then hold the shares on trust for each participant for a predetermined period. The shares would eventually vest in each of the executives in question only as certain vesting criteria were met. Those vesting criteria related to the performance conditions that the company wanted to agree with each senior executive.

Each trustee then granted a Put Option in favour of each participant in respect of the shares the trustee was holding for them. The granting of the Put Option was in consideration for the granting of a Call Option by each participant back to the trustees again relating to each of the executives' beneficially-owned shares. These options could be exercised where the vesting criteria with respect to each executive was not met.

The arrangement also proposed the payment of bonuses by the company to the executives under various terms and conditions which are not currently relevant. These bonus payments would also be made, however only when the vesting criteria was met.

Being a responsible company, the employer wanted to be sure as to which amounts of consideration arising under this arrangement would be treated as solely attributable to the shares, which amounts would be treated as consideration solely attributable to the Put and/or the Call Options and how much of the consideration would be treated as solely attributable to the underlying employment contracts.

Under the financial arrangement rules, certain arrangements are treated as excepted financial arrangements: s EW 5. Section EW 5 lists some 23 categories of arrangement that are classified as excepted financial arrangements. Particularly relevant here is s EW 5(13), which provides:

> A share, or an option to acquire or to dispose of shares, is an excepted financial arrangement, if the share is acquired, or the person becomes a party to the option, on or after 20 May 1999. This subsection does not apply to a withdrawable share or to an option to acquire or to dispose of withdrawable shares.

The shares to which the arrangement applied are excepted financial arrangements pursuant to this section as they are both of the options in question. Section EW 5(4) provides that employment contracts are also excepted financial arrangements.

Section EW 6(2) provides that any amount that is solely attributable to an excepted financial arrangement of the sort listed in section EW 5(2) to (16) is not an amount that is taken into account under the financial arrangement rules.

Consistent with how other determinations are set out, special determination S33 then provides for the method by which the various considerations are going to be attributable. Accordingly consideration amounts paid for the shares will be solely attributable to those shares and hence solely attributable to an excepted financial arrangement. Those amounts would not need to be taken into account under the financial arrangement rules.

In practical terms, therefore, the amounts subscribed by the trustees for shares and the amounts paid for the transfer of unallocated shares, shares received by the trustees and dividends on these shares will be solely attributable to the shares.

Similarly, with respect to the Put and Call Options consideration amounts relation to the issue of the call option by any of the executives as consideration the issue of the put option and around the other way would be solely attributable to the options. The purchase price paid by the trustee for the transfer of any of the participants' beneficial interest in shares would also be solely attributable to those options.

Bonuses which relate to the underlying employment contract would also be excepted from the financial arrangement rules.

In practical terms, therefore, the following amounts would be solely attributable to excepted financial arrangements: the amounts relation to the share subscription, the acquisition of shares; the dividends received over the restrictive period; the transfer of beneficial interests in shares; and the purchase price for the beneficial interest in shares.

However the following amounts must be taken into account under the financial arrangement rules and that is the loan dividends if they applied to partially repay the loan in any loan repayments.

The next employment related statement emanating from the Department is the Exposure Draft with respect to a question the Department had been asked, headed up QB 15/X1. The Exposure Draft is seeking comment. It is issued for discussion purposes only.

The question is directed at what the income tax treatment is with respect to a life insurance policy that is taken out by an employee, where the employee is the policyholder but where the premium is paid by the employer on the employee's behalf. This question arose because the department has recently reviewed some of its older public information bulletins and doing so came across items written before fringe benefit tax was introduced and before desk duties were removed. The two items are of some antiquity, at given the lifespan of tax legislation, one being Public Information Bulletin No 70 published in December 1972 the other being Public Information Bulletin No 106 published in July 1980.

It was that which prompted the publication of this Exposure Draft. QB 15/X1 concerned the situations where the employer is simply paying the premium in respect of the life insurance policy. The life insurance policy to which the Exposure Draft is directed is a term life policy where a lump sum is paid if the person dies during the term of the policy.

The position advocated by the Department in this exposure draft is that a person is allowed deduction for the amount of expenditure or loss incurred by them in the course of carrying on business for the purposes of deriving assessable income. From a business's perspective ordinarily wages and staff costs are deductible because they have the necessary nexus with the direct derivation of gross income. This will not always be the case. For example, the staff wages attributable solely to a capital expenditure program would not be deductible in a typical situation.

With respect particularly to the life insurance costs, the view taken by the Department is that as long as the staff member's salary or wages are deductible then the costs of paying the insurance premiums will also be deductible. The rationale here is that the terms and conditions of the employment relationship place an obligation on the employer to pay the employee's life insurance premiums. Absent agreement of that sort, it is difficult to see why an employer would be meeting such expenses.

The department then moves on to look at the tax issues falling out for the employee. The department notes that employment income is defined in s CE1(1)(b) as including expenditure on account. Expenditure on account is in turn defined in s CE5(1) as meaning a payment made by an employee relating to expenditure incurred by an employee. The department reasons that in this situation the employee has a legal obligation to meet the insurance premiums due to the insurer. Because that legal obligation is being met on these facts by the employee are the payment of the premiums as expenditure on account of the employee and is therefore included with the concept of employee's income.

Moreover, payment of expenditure on account of an employee is included, by virtue of section RD(5)(2), within the concept of salary or wages. As a consequence the employee then must deduct PAYE from the insurance premiums. The department notes that because the premium is assessable income to the employee the fringe benefits tax rules do not apply: see s CX4.

If the employee dies the lump-sum payout under the insurance policy is not income.

The third publication is another Exposure Draft, entitled QB 15/X2. Like Exposure Draft QB 15/X1 it arises out of the same review of historic Public Information Bulletins. The scenario that this Exposure Draft addresses is where the term life insurance policy is taken out by the employer for the benefit of the employee. In this context the concept of an employee includes for the benefit of the person's spouse, civil union partner, de facto partner, or child.

Again the department begins by looking at deductibility premiums from the business-owner's perspective. The same implicit rationale is present, namely that the employment contract requires these payments to be met by the employer.

With respect to employee's income the position is slightly more fraught. Section CE5(2) defines expenditure on account of an employee as including premiums paid by the employer who takes out life insurance policies for the benefit of an employee or their family members. However that subsection is overridden by subs (3)(f) to (i). That subsection excludes from the concept of expenditure on account any premiums relating to particular types of policies. One of the exclusions is a premium that an employer pays on a life insurance policy taken out to the benefit of an employee or their family if the premium cannot be refunded or converted into cash by the employee or their associates and the only benefits payable under the policy of those payable on death of the employee or their spouse: see subs (f).

The other relevant subsection is (g) which provides that expenditure on account of an employee does not include a premium that an employer that is a close company pays a life insurance policy taken out the benefit of employee to the extent to which the expenditure is treated as a dividend under subpart CD. That particular complication is not addressed in this exposure draft.

It is clear, however, that paragraph (f) applies to exclude the premiums in this example of being treated as expenditure on account of the employee. Because such expenditure is not on account of an employee it is not income to the employee and it is therefore necessary to look at the FBT rules.

A review of those rules shows that the payment of the premium will constitute a fringe benefit. If the life insurance policy is triggered by death and the payment is made then again that receipt is not assessable income.