Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

February 2019

taxworkingroup.govt.nz/key-documents

This paper has been prepared by the Secretariat to the Tax Working Group for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;
[2] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials;
[3] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions;
[4] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Coversheet: **ETCI: Valuation Day**

Position Paper for Session 20 of the Tax Working Group
12 October, 2018

Purpose of discussion

The purpose of this paper is to provide the Group with further information and analysis to assist with the Group's recommendations on rules for a "Valuation Day" under an extension of taxation of capital income.

It also proposes draft text for inclusion in the Final Report (Appendix A).

Key points for discussion

This paper:

a. Discusses the interim decisions the Group has made about Valuation Day.

b. Provides further advice about potential rules for valuing assets on Valuation Day, including discussion on the operation of the "median rule" proposed by the Group.

c. Provides advice on particular valuation options that could be considered.

Recommended actions

We recommend that you:

a. **agree** to the legislation referring to "a value", and the Commissioner of Inland Revenue publishing guidance on acceptable valuation methods.

b. **agree** to use a "median rule" for all assets, except for listed shares, on Valuation Day.

c. **agree** to Appendix C being used as the basis for draft text for the Final Report.

ETCI: Valuation Day

Position Paper for Session 20
of the Tax Working Group

October 2018

Prepared by Inland Revenue Department and the Treasury

TABLE OF CONTENTS

1. Introduction

1.1 Purpose

1. In Appendix B to the Group's Interim Report, the Group proposed that the new rules for the extension of taxation of capital income should be introduced for all affected assets from a particular date (referred to as "Valuation Day"). This would mean that taxable gains and losses would be calculated based on the increase or decrease in value of the assets after Valuation Day.

2. The purpose of this paper is to provide the Group with further information and analysis to assist with the Group's decisions on rules for valuing assets on Valuation Day.

3. The paper will recap why the Group is proposing a Valuation Day approach. It will outline the decisions the Group has already made. It will also provide further discussion and recommendations on how a "median rule", proposed by the Group in their Interim Report, could work in practice.

1.2 Content and scope

4. In its Interim Report, the Group said consideration should also be given to whether the median rule would be appropriate in other transitional situations, for example when a person migrates to or from New Zealand, or a house becomes or ceases to be an "excluded home".

5. Discussion of the median rule in respect of migration will be included in a paper for session 22 (ETIC: International aspects).

6. Following consideration of the paper on the excluded home, in session 19. The Group has decided a Valuation Day type approach should be adopted for situations where a house becomes or ceases to be an "excluded home". This is covered in more detail below.

2. Problem definition and objectives

2.1 Policy problem or opportunity

7. Generally, capital gains taxes have been introduced in other countries either:

   - for all affected assets, with effect from a certain day, on the basis that gains and losses from that day on are in the base (this was the approach taken by South Africa); or
   - only for assets acquired on or after a certain day (this was the approach taken by Australia).

8. If the Group recommends an extension to the taxation of capital income, the Group has decided it would apply for all affected assets, with effect from a "Valuation Day".

9. This approach was favoured because it reduces the lock-in effect which occurs in relation to assets acquired before the new rules are implemented. However, this approach means a cost base will need to be established for all affected assets as at the Valuation Day.

10. This paper considers options for dealing with the need to establish a cost base on Valuation Day for affected assets.

2.2 Stakeholder considerations

11. The Secretariat considers that valuable input on this issue could be obtained from the private sector, and in particular from registered valuers. The Secretariat has not had an opportunity to carry out any consultation on this issue prior to submitting this paper. However, The Secretariat recommends that this be done prior to issuing the Group's final report.

3. Valuation options

3.1 Policy considerations about valuation options

12. The Group has noted that if all assets need to be explicitly valued for Valuation Day, this would impose a significant cost on many taxpayers. Some kinds of assets are much easier to value than others. For example, valuing listed shares and other assets that are regularly traded should be relatively straightforward in most cases. However, valuations for other assets may be unreliable or require incurring significant compliance costs to obtain (for example, obtaining a reliable value for a private company, or of goodwill associated with a business, is likely to require significant time and expense). Furthermore, no matter how much time is taken or expense incurred, market value will inevitably be approximate rather than precise.

13. In determining the best method to be used for valuation, it is helpful to take into account various policy considerations. These considerations can then be weighed and decisions can be made about which are more important in this context. The Secretariat has identified the following factors that appear to be relevant for the design of rules for Valuation Day:

    - **Level of compliance costs** – The level of costs that taxpayers will be required to incur in order to comply with the rules is a major consideration
    - **Simplicity and certainty** – Simple rules are easier for taxpayers to understand and apply, and reduce risk of disputes that are costly to both the taxpayer and the Commissioner. However, simplicity can lead to a lack of accuracy.
    - **Accuracy** – Rules that require very precise valuations give rise to a more accurate tax outcome. However, such rules are often complex and time consuming for taxpayers to apply.
    - **Integrity** – Recognising that there will often be a range of acceptable valuations, rules that are more certain will provide fewer opportunities for some taxpayers to "push the boundaries" of what may be acceptable.

14. It is also helpful to take account of the rules that apply in other countries when determining appropriate rules for New Zealand, because they have dealt with the same issues before. On this basis, a brief summary of the rules that applied in some other countries which used a Valuation Day is included at Appendix C.

15. Ultimately, the Secretariat considers that the appropriate policy setting for the design of rules for Valuation Day is to design rules that are simple to apply for the average taxpayer, and that do not involve significant compliance costs. The rules also need to ensure that all owners of capital assets in New Zealand will not be required to obtain professional valuations of all of their assets on the same day. Such a requirement would place an unmanageable burden on valuers, and unreasonable compliance costs on taxpayers. While allowing this valuation to be obtained at a later date, such as when the asset is sold or at the expiry of a set

period, would partially mitigate this issue it would still require taxpayers to incur compliance costs.

16. For that reason, the Secretariat recommends that the rules for Valuation Day need to provide taxpayers a choice between accuracy and low compliance costs. They also need to allow for different valuation options for different types of assets. The Secretariat would prefer to err on the side of more liberal rules that do not achieve absolute accuracy, than on less liberal rules that give rise to unreasonable costs for taxpayers.

3.2 Options for valuation

17. Options that could be used for valuation are outlined below. Rather than being options that the Group needs to choose one of, the Secretariat sees these as being options that will apply better to some assets than to others. However, the Group could choose to have default valuation options for each kind of asset, for any taxpayer that does not want to make a choice.

18. The Secretariat notes that it is necessary under current law to ascertain market values in a number of circumstances described in the Income Tax Act 2007 and Goods and Services Tax Act 1985. The definition of "market value" varies slightly for the purposes of the different regimes for which it is required; however the definitions tend to rely on common concepts like an arm's length price, i.e. the price that would be agreed between a willing buyer and a willing seller. The legislation is generally not prescriptive about how to ascertain value, but instead that 'void' is filled by guidance issued by Inland Revenue. An example of one of these guidance statements is included in Appendix B.

19. Inland Revenue could prepare guidance, like the statement in Appendix B, on the valuation methods the Commissioner would find acceptable for the various classes of assets that would be brought into the tax base on Valuation Day.

20. The effect of a Commissioner's Statement would be to provide taxpayers with safe harbour valuation methodologies which the Commissioner will accept. It would also provide guidance as to the information the taxpayer should retain to support the valuation.

21. The statements would not be intended to provide a definitive and comprehensive set of valuation techniques, so that taxpayers could still apply other valuation methodologies that determine the value of the affected asset. There are existing examples where alternative methodologies can be used. The statements would instead require that if another valuation methodology is used, the valuation must reflect the market value of the asset on the Valuation Day.

22. The Secretariat notes that absolute accuracy would not be expected in all scenarios (as accuracy depends in part on the data available and on subjective judgement). However, it would be reasonable to expect that an appropriate process is followed when determining the value at Valuation Day.

23. It would also expected that the valuation method, and any input assumptions used to prepare the valuation, should be fully documented and retained as the Commissioner may request to examine the documentation. Where a taxpayer adopts a method not outlined in the statements, they should also retain the documentation outlining the reasons for adopting the alternative method.

3.3 Some potential general options:

Actual value

24. Some assets have easily obtainable market values. Assets that would fall into this category would be:

- listed shares; and
- other things traded on exchanges (e.g. certain commodities) (though these are likely to be subject to tax already as inventory).

25. If shares are listed in New Zealand, their value on Valuation Day could be the closing price on the day before; however, this could create the risk of prices being manipulated due to the relative illiquidity of some New Zealand shares. A volume weighted average price, as discussed below (at paragraph 41), would help address this.

26. If the shares are not listed in New Zealand but are listed on one or more overseas recognised exchanges, the foreign value will need to be converted to its New Zealand Dollar equivalent. The most common method for currency conversion under existing rules is to apply the close of trading spot exchange rate. This will only apply to Australian shares or investors with shares that cost less than $50,000 as portfolios above this value will be applying the Fair Dividend Rate method.

27. If the shares are listed on more than one recognised exchange, the listed price could be based firstly on the recognised exchanges in the taxpayer’s country of residence, or, if that is not applicable, on the average of all the listed prices as converted to New Zealand dollars.

28. In Appendix B to the Interim Report, the Group set out their preliminary conclusions with regard to valuations, and suggested that where International Financial Reporting Standards (IFRS) rules require assets to be valued at fair market values, the value on Valuation Day could be the value adopted under those rules. The Secretariat notes that, although taxpayers who use IFRS are required to update the fair value calculation in their accounts regularly, care would need to be taken if referring to the fair value amounts as shown in the books at a certain date (e.g. fair values may not have been updated for some time). Further goodwill, while valued at the date of acquisition, is usually not revalued subsequently under the fair value rules, although it can be impaired., Therefore its value at a certain date may be historic.

Arm's length valuation

29. An arm's length value determined by an independent, suitably qualified valuer.

30. Similar terminology was recently introduced in the Base Erosion and Profit Shifting (BEPS) changes to valuation of assets for thin capitalisation purposes.

Straight-line (pro-rating)

31. Another approach could be to allow a person to determine the value of their asset on Valuation Day by allowing them to pro rate the change in value over the time they have held the asset. This option was also briefly raised by the Group in Appendix B to the Interim Report.

32. Under this approach, at the time an asset is sold, the owner would determine the total gain on sale derived over the whole period of ownership, and then determine what proportion of that gain was derived after Valuation Day. This is illustrated by the following example.

> ***Example 6 – straight-line***
>
> John purchased a small trucking business on 1 April 2015 for $200,000. On 31 March 2025 (ie, 10 years later), John sells the business to Paul for $600,000 (ie, a $400,000 gain).
>
> As a result of the extension of the taxation of capital income, John will have to pay tax on the capital gain he has derived since Valuation Day (1 April 2021) from the sale of the business (ie, for the last 4 years he owned the business).
>
> Applying a straight-line approach, John will have to pay tax on 4/10th of the gain on sale (ie, $160,000).

33. The downside with this option is that it may be difficult to apply to assets whose cost base includes a number of items of expenditure spread over a number of years, or where taxpayers are unlikely to have kept a track of the cost base. Perhaps the most common example would be a sale of a business which has been developed by the vendor.

34. A further downside is that the value is likely to be inaccurate where assets have not grown at a consistent rate before and after the Valuation date. For example, a start-up business that reaches a plateau, or residential property which has grown significantly in recent years but may not increase at the same rate in coming years. However, given the inherent uncertainty of valuations, this may not be seen as an issue in most cases.

3.4 Other options for real property

Comparable properties

35. A review could be undertaken of comparable properties sold around the time of Valuation Day. This service is already offered through a number of websites using

algorithms based on recent close sales, Ratings Valuations and other comparable data such as property size and features. A prime example of this is QV valuations.

Rateable value

36. A property's value could be the Ratings Valuation (RV) (plus any capital costs incurred since the date the RV was published);

37. The RV chosen could be the closest before or after Valuation Day.

38. As the RV is used to assess local authority rates there would be a natural tension with property owners wanting a low RV for rates purposes and a high RV for Valuation Day.

39. There is a public perception that RVs are often significantly lower than a property's value. The Secretariat will consult with relevant private sector experts to ascertain if the perception is accurate across all of New Zealand. If the taxpayer is concerned that RVs for property in their area are not comparable to market sale prices, they would be unlikely to choose this option.

Māori freehold properties

40. The Valuer-General applies a discount rate when valuing Māori Freehold Land for the purposes of the district valuation roll. This is to recognise that legal restrictions under the Te Ture Whenua Māori Act 1993 on owners' ability to sell Māori Freehold Land have an effect on the value of that land.[1] Further consideration will be given to the underlying policy intent of the discount rate as well as the Group's intended principles in respect of extending the taxation of capital income. This analysis will be incorporated into the collectively-owned Māori assets paper that will be provided to the Group following consultation.

3.5 Other options for shares

Volume weighted average price

41. Volume weighted average price ("VWAP") over the last five trading days (including the acquisition date) for the listed share.[2] VWAP is currently available upon request from the New Zealand Stock Exchange, for shares listed on the NZX. VWAP is already approved for valuing shares provided in an employee share schemes to smooth out short-term fluctuations in share prices immediately before the Valuation date.

[1] The Valuer-General's approach reflects the Court of Appeal's decision in *Valuer-General v Mangatu Inc* [1997] 3 NZLR 641.

[2] VWAP calculates the average price of an asset based on all sales over a set period, such as five days. This is weighted by the size of the trades so that a large trade has a bigger impact on the VWAP than a smaller trade at the same price.

42. The Secretariat will need to discuss this option with the New Zealand Stock Exchange to determine how feasible this will be in practice. It is possible that the Exchange could publish on its website VWAPs for all listed shares on the Valuation Date.

Recent transactions

43. For unlisted shares, a valuation based on the company's most recent arm's length commercial transaction in the last six months.

3.6 Revenue account property

44. The Secretariat notes that property that was already "revenue account property" will not need to be valued on Valuation Day. "Revenue account property" is defined in the Income Tax Act 2007, as property that:

- is trading stock; or
- if disposed of for valuable consideration, would give rise to income for the person under the Income Tax Act (with some exceptions).

45. Examples of revenue account property are, personal property acquired for the purpose of disposal, and land that is subject to the land provisions (for example land acquired for a building business, or used for a major development).

46. Revenue account property is already subject to tax on sale, with a deduction allowed for the "cost of revenue account property" (which is broadly the costs of acquiring or developing the asset) at the time of sale. Therefore, people who own revenue account property will already need to have a record of the relevant acquisition and other development costs.

47. People who hold revenue account property will continue to be taxed on the gain that has arisen over the whole period they have owned the property, and not just from Valuation Day.

Example 6 – revenue account property

In 2018, Penelope purchased a section of land in Tauranga with the intention of subdividing it into four sections and selling off the sections. Under the current law, Penelope will be taxed on the sale of the sections under s CB 12 (Disposal: Schemes for development or division begun within 10 years). Therefore, the land is revenue account property.

Penelope is still in the process of developing the land on 1 April 2021 (Valuation Day). Penelope will not need to obtain a valuation of the land on Valuation Day. Instead, when Penelope sells the land she will be entitled to a deduction for the actual cost of acquiring the land, plus any development costs.

3.7 Default options

48. The Group might like to consider default valuation options which could be set for each kind of asset. These could operate either as mandatory valuation methods or as a backstop to all the other options for taxpayers who might not want to consider a range of options. For example, a default option for unlisted shares might be the straight-line method, whereas the default option for real property might be based on one of the RVs before and after Valuation Day, or the QV.

49. It is important to note that, if mandatory methods are not set, and the options available are seen as systematically under-valuing the property, the rules may incentivise taxpayers to incur valuation costs to increase their Valuation Day cost base. Equally, if mandatory methods are preferred, they would likely have to be generous to avoid an adverse public reaction.

4. The median rule

4.1 Application of the median rule

50. In Appendix B to the Group's Interim Report, the Group proposed that a "median rule" could be used in calculating the eventual gain or loss when an asset is realised. The objective is to remove gains and losses that arose before Valuation Day but that have not actually arisen looking at the period of ownership as a whole (i.e. if an asset gains in value before valuation day then declines after this or vice versa). Using the median rule, the amount to be deducted from the sale price would be the median of:

- the actual cost, including costs incurred both before and after Valuation Day;
- the value on Valuation Day, plus costs incurred after Valuation Day; and
- the sale price.

Example 1 – median rule

In 2014 Ben bought a rental property for $500,000. He hired a registered valuer to establish the market value of his property on Valuation Day. The valuer said the property was worth $650,000. Ben sold the property two years after Valuation Day for $800,000.

Applying the median rule:

Cost = $500,000

Valuation Day = $650,000

Sale price = $800,000

The median value is $650,000. Therefore, Ben is able to deduct $650,000 from the sale price of $800,000, giving rise to a $150,000 taxable gain.

Example 2 – median rule with cost incurred before Valuation Day

In 2014 Ben bought a rental property for $500,000. He spent $50,000 installing a new kitchen, and adding an extra bedroom. On Valuation Day the property was worth $450,000. Ben sold the property two years after Valuation Day for $900,000.

Applying the median rule:

Cost = $500,000 plus the $50,000 in capital costs incurred

Valuation Day = $450,000

Sale price = $900,000

The median value is $550,000. Therefore, Ben is able to deduct $550,000 from the sale price of $900,000, giving rise to a $350,000 taxable gain.

51. The main benefit of a median rule is that it smooths out the artificial or paper gains or losses that can occur from imposing an arbitrary date on which assets must come into the tax base. In particular, it means that:

- a Valuation Day value which is higher than the actual cost and sale price will not create, or increase, a deductible loss because the value of the asset (e.g., a share) was unusually high on Valuation Day; and
- a Valuation Day value which is lower than actual cost cannot increase a taxable gain above the actual gain, or turn an actual loss into a taxable gain.

Example 3 – Valuation Day higher than actual cost

Greg holds shares in an unlisted company, Task Limited, which he purchased for $5,000. On Valuation Day, based on an independent valuation, the shares are worth $8,000. Greg sells all the shares three years later for $5,500.

Applying the median rule:

Cost = $5,000

Valuation Day value = $8,000

Sale price = $5,500

The median value is $5,500. Therefore, Greg will have no capital gain on sale (ie, $5,500 less $5,500).

Without the median rule, Greg would have a capital loss post Valuation Day of $2,500 (ie, sale price of $5,500 less Valuation Day value of $8,000). However, he has made a $500 gain since he originally purchased the shares.

With the median rule, the large spike in the price of the shares is smoothed out, and his actual tax position is closer to his real position.

Example 4 – Valuation Day lower than actual cost

Greg holds shares in Task Limited, which he purchased for $5,000. On Valuation Day, based on an independent valuation, the shares are worth $3,000. Greg sells all the shares three years later for $5,500.

Applying the median rule:

Cost = $5,000

Valuation Day value = $3,000

Sale price = $5,500

The median value is $5,000. Therefore, Greg will have a capital gain on sale of $500 (ie, $5,500 less $5,000).

Without the median rule, Greg would have a taxable capital gain post Valuation Day of $2,500 (ie, sale price of $5,500 less Valuation Day value of $3,000). However, he has only made a gain of $500.

With the median rule, Greg's taxable gain reflects his actual gain.

52. Where a person has incurred post-Valuation Day costs which have to be capitalised, those costs should also be taken into account, both in calculating the original cost, and in determining the Valuation Day value. This should generally ensure that the impending introduction of the tax does not affect decisions as to when capital expenditure is incurred.

> ***Example 5 – costs incurred after Valuation day***
>
> A person owns a building damaged by an earthquake. The cost of the building before the earthquake was $8 million. The value of the building immediately before the earthquake was $12 million. The earthquake reduced the value to $9 million.
>
> The owner intends to pay $3 million to bring the building up to code, which will restore the value to $12 million (ie, $9 million post-earthquake value plus $3 million remedial costs).
>
> The cost of the building should also be increased by the $3 million of remedial costs, resulting in a cost of $11 million.
>
> If this money is spent before the Valuation Day, then the value of the building on Valuation Day will be $12 million (ie, the remediated value). If the money is spent after the Valuation Day, then the valuation figure will be the $9 million valuation plus the $3 million of post-Valuation Day costs for a figure of $12 million. The tax treatment of any sale should be the same, regardless of when the repairs are done.

53. Even with a median rule, there is a risk from inaccurate Valuation Day valuations. If taxpayers artificially inflate the Valuation Day value, there would be no, or a reduced, taxable gain on a profitable sale (since the sale price would be the median price). However, Inland Revenue would be able to challenge the valuation under existing rules if they consider it to be unreasonably high.

54. The median rule also does not protect against an inaccurately low Valuation Day value which could result in unrealised gains on Valuation Day becoming subject to tax upon the asset's sale.

55. Furthermore, while the median rule will be beneficial in protecting against paper gains or losses, a valuation of assets is still required on Valuation Day, which raises compliance cost issues.

> **Limiting rule – Independent Advisor comment**
>
> The Independent Advisor considers it is more intuitive to describe the median rule as a limiting rule by applying the following steps:
>
> a. Sale proceeds less valuation on Valuation Day.
>
> b. If a. is a gain and valuation is lower than cost, then the gain is reduced by difference between cost and valuation.
>
> c. If a. is a loss and valuation is higher than cost; loss is reduced by difference between valuation and cost. This is to be capped at zero.

4.3 Median rule for listed shares

56. Although the median rule could also be applied to listed shares, an alternative option the Secretariat recommends the Group to consider would be to exclude listed shares from the application of the median rule. This benefits of excluding listed shares from the operation of the median rule are:

- certainty of valuation;
- incentive to sell and buy-back; and
- effect on funds.

57. As listed shares have a certain value at any particular time the requirement to determine a valuation on Valuation Day will not require an estimated value. This means that any gains or losses derived or incurred before Valuation Day can be removed and only subsequent gains and losses, as opposed to an estimate of gains and losses, can be subject to tax.

58. The effect of imposing a median rule on a person with listed shares would be to incentivise them to sell all their shares that have increased in value on Valuation Day and buy them back. This would impose compliance costs without achieving any economic benefit. This is best explained by the examples below.

Example 6 – listed shares that have increased in price

In 2018 Ronnie purchased shares in A Co for $20 each. On Valuation Day the shares have risen in value to $50 each. If the median rule applies Ronnie will sell and buy-back the shares because:

If the shares drop to $30 he will be able to access the $20 loss whereas if he had held the shares the whole period no loss would have been available under the median rule.

If the shares increase to $60 he will be taxable on the $10 gain but this is the same as under the median rule.

Example 7 – listed shares that have decreased in price

In 2018 Ronnie purchased shares in A Co for $20 each. On Valuation Day the shares have decreased in value to $10 each. If the median rule applies Ronnie is always better off holding the shares (ie, not selling and buying back).

If the shares drop to $7 a loss of $3 is available with or without the median rule

If the shares increase to $13 a gain of $3 would be taxable without the median rule or no taxable gain with the median rule.

If the shares increase to $25 a gain of $15 would be taxable without the median rule or $5 taxable gain with the median rule.

59. The net effect of these two examples is that, even if the rules were to attempt to impose the median rule on listed shares, in practice it would only be optional. It is also consistent with the view on roll-over that losses from listed shares should be ring-fenced because they are able to be easily “cherry picked”.

60. A fund will not want to apply the median rule as it would cause equity concerns between investors who bought shares before and after Valuation Day.

Example 8 – listed shares owned by a fund

A managed fund bought shares before Valuation day for $1,000 which have increased to $1,500 on Valuation Day. Over the next month the shares decline to $1,200 but continue to be held by the fund.

On Valuation Day Hayley buys 1% of the fund for $15 and sells out of the fund one month later for $12.

Hayley expects to receive a $3 loss allocation from the fund for tax purposes. However, if the fund has applied the median rule the Valuation Day value is $1,200 so there is no taxable gain or loss that can be attributed to Hayley.

Also, the Group is to consider at a future meeting whether accrual treatment is appropriate for managed funds. If that option is taken further, and the median rule remains in place for listed shares owned outside of funds, individuals who invest in funds are likely to be taxable on paper gains after valuation whereas direct investors would not be.

61. However, the Secretariat recognises that not using the median rule for listed shares will mean that investors would be subject to tax on paper gains (ie, where the share price is lower on Valuation Day than the actual cost and sale price of the shares, so that a person is taxed on a gain that they did not actually receive).

The Independent Advisor's preference is for the median rule to still apply to listed shares. As seen in the above example, without a median rule, paper gains will be taxed in the event that the market falls ahead of valuation day.

5. Valuing the “excluded home”

62. The Group has decided that a valuation will be required where there is a change of use of an “excluded home” (e.g. from an “excluded home” to a rental property or vice versa). The options in the previous chapters, including the median rule, could apply similarly when applied to a single change of use from an “excluded home” to a non-excluded home treating the date of change the same as a Valuation Day.

Example 9 – house ceasing to be an excluded home

In 2018 Chris buys a house for $500,000 which he lives in. On 1 April 2023 Chris buys a second house, which he moves into, and rents out his first house which now has a value of $750,000. On 31 March 2025 Chris sells the first house for $800,000.

Applying the median rule:

Cost = $500,000

Valuation on 1 April 2023 = $750,000

Sale price = $800,000

The median value is $750,000. Therefore, Chris is able to deduct $750,000 from the sale price of $800,000, giving rise to a $50,000 taxable gain.

63. Where a property changes use to an “excluded home” the median rule can also be used to determine the deemed sale price. This will mean any gain on sale will be capped at the overall gain on the sale, including the period it was an “excluded home”.

Example 10 – house becomes an excluded home

On 1 April 2021 Lucy buys a rental property for $500,000. On 1 April 2023 Lucy moves into the property and it becomes an excluded home. At this date the property is valued at $750,000. Lucy sells the property for $600,000 on 31 March 2025.

Applying the median rule:

Cost = $500,000

Valuation on 1 April 2023 = $750,000

Sale price = $600,000

The median value, to determine the deemed sale price, is $600,000. Lucy is able to deduct $500,000 from the deemed sale price of $600,000, giving rise to a $100,000 taxable gain. Without the median rule Lucy would have had a $250,000 taxable gain even though she sold the house for only $100,000 more than she paid for it.

64. Where there is more than one valuation, such as when a property is subject to two (or more) changes of use, the median rule cannot easily be applied as there are now more than three values and the relevant three to consider depend on their relative size.

65. It is, however, possible to apply general rules along the lines of the limiting rule described above which will follow the same principles as the median rule. This would be:

- A person is taxable on any change in the valuations during the period the property was not an excluded home; however:
    - Gains during the period the property was not an excluded home cannot exceed total gains over the period the property is owned.
    - Losses during the period the property was not an excluded home cannot exceed total losses over the period the property is owned.

Example 11 – house changes use twice

On 1 April 2021 Neil buys a house to live in for $500,000. On 1 April 2023 Neil moves to New York for a two-year sabbatical and rents his house out while he is away. His house is valued at $600,000.

On 31 March 2025 Neil returns to live in his house which is now valued at $580,000. Neil eventually sells his house on 31 March 2030 for $800,000.

Applying the median rule:

Cost = $500,000

Valuation on 1 April 2023 = $600,000

Valuation on 1 April 2025 = $580,000

Sale price = $800,000

During the period the house was not an excluded home it decreased in value by $20,000. However, during the whole period of ownership the house increased in value by $300,000 therefore no taxable loss is available.

66. If the Group is concerned that applying a "valuation" approach to changes of use might lead to anomalous results, a better way to avoid these than using the median rule might be to reconsider the use of a time-based apportionment of actual gain or loss.

6. Conclusion and recommendations

6.1 Recommended approach

67. If the Group recommends an extension to the taxation of capital income, the Group has decided it would apply for all affected assets with effect from a Valuation Day. This approach was favoured because it reduces the lock-in effect which occurs in relation to assets acquired before the new rules are implemented.

68. It may not be necessary to specify in legislation how Valuation Day values are determined. Legislation could require taxpayers to determine a valuation and rely on guidance from Inland Revenue on appropriate methods. This method would provide greater flexibility for taxpayers to choose a method that best matches their circumstances.

69. The Secretariat recommends a list of valuation options that taxpayers can choose from, in order to balance compliance costs, simplicity and accurate valuations.

70. There are a number of different valuation options, some of which will apply more appropriately to certain asset classes. Options include:

- Actual value – this will typically only apply to assets that have easily obtainable values such as listed shares.
- Arm's length valuation – this will generally be the most accurate but will require high compliance costs to obtain independent valuations.
- Straight line – this may be best applied to difficult to value assets such as small businesses.

71. There are also options which apply specifically to real property:

- Comparable properties – this could be done on a case-by-case basis or using an algorithm which are already commonly available (for example QV valuations).
- Ratings valuation – this is easily obtainable but is likely to be inaccurate and public perception of that inaccuracy may be even greater.

72. The existing rules already require valuation of shares in a number of situations. Two methods which are already established are:

- Volume weighted average price – this smooths out temporary fluctuations in asset value of listed shares immediately before Valuation Day.
- Recent transactions – this may be suitable for unlisted shares when there has been a comparable transaction within a recent period such as six months.

73. Property that is already revenue account property will not need to be valued on Valuation Day as this property is already subject to tax on sale so values are already held.

6.2 Median rule

74. In Appendix B to the Group's Interim Report, the Group proposed that a median rule could be used in calculating the eventual gain or loss when an asset is realised. The amount to be deducted from the sale price would be the median of:

- the actual cost, including costs incurred both before and after Valuation Day;
- the value on Valuation Day, plus costs incurred after Valuation Day; and
- the sale price.

75. A median rule smooths out the artificial paper gains or losses that can occur from imposing an arbitrary date on which assets must come into the tax base.

76. The Secretariat recommends the Group consider excluding listed shares from the median rule, but note that the independent advisor's preference is for the median rule to apply to all assets.

6.3 Valuing the family home at change-in-use date

77. The valuation rules outlined above could also be used in the event of a change in use from an "excluded home" to an income earning use or vice versa. However, where there are multiple changes in use the median rule is very complex to apply. Therefore, the Secretariat recommends general rules following the same principles. A simpler alternative that would also avoid valuations giving anomalous results would be to use a time-based apportionment of actual gain or loss.

6.4 Costs, benefits and risks of recommended approach

78. The use of a median rule will reduce the need for a loss ring-fencing rule as taxpayers will not be able to claim losses on assets that have a higher value on Valuation Day than their cost price or their sale price.

79. The median rule will also prevent taxpayers being subject to tax on artificial paper gains that arise only due to the value on Valuation Day being lower than the cost price and the sale price. This would remove one potentially controversial feature that could otherwise arise.

80. A range of options should be available for taxpayers to determine the value of assets on Valuation Day. This will allow taxpayers to choose the method that best matches their circumstances and balances the competing priorities of compliance costs, simplicity, certainty and accuracy.

81. It is important that some of the available methods are perceived as arriving at a reasonable valuation without incurring significant compliance costs. If this is not the case taxpayers will be required to obtain independent valuations which may

place an unmanageable burden on valuers, and unreasonable compliance costs on taxpayers.

82. The Secretariat would prefer to err on the side of more liberal rules that do not achieve absolute accuracy, than on less liberal rules that give rise to unreasonable costs for taxpayers or effectively move unrealised gains from prior to Valuation Day into the tax base.

Appendix A: Suggested text for Final Report

Valuation Day

1. The Group proposes that all assets covered by an extension of the taxation of capital income should be brought into the base with effect from a Valuation Day. This approach is favoured because it reduces the lock-in effect which occurs in relation to assets acquired before the new rules are implemented.

Valuation options

2. It is important that some of the available methods are perceived as arriving at a reasonable valuation without incurring significant compliance costs. If this is not the case taxpayers will be required to obtain independent valuations which will place an unmanageable burden on valuers, and unreasonable compliance costs on taxpayers.

3. Current tax legislation which refers to "value" is generally not prescriptive about how to ascertain the value, but instead that 'void' is filled by guidance issued by Inland Revenue. This guidance provides taxpayers with safe harbour valuation methodologies which the Commissioner will accept, and what information the taxpayer should retain to support the valuation.

4. The Group proposes that Inland Revenue should publish guidance on what valuation methods the Commissioner would find acceptable for the various classes of assets that would be brought into the tax base on Valuation Day.

5. There are a number of different valuation options, some of which will apply more appropriately to certain asset classes. Options include:

   - Actual value – this will typically only apply to assets that have easily obtainable values such as listed shares.
   - Arm's length valuation – this will generally be the most accurate but will require higher compliance costs to obtain independent valuations.
   - Straight line – this may be best applied to difficult to value assets such as small businesses.

6. There are also options which apply specifically to real property:

   - Comparable properties – this could be done on a case-by-case basis or using an algorithm which are already commonly available (for example QV valuations).
   - Ratings valuation (RV) – this is easily obtainable but may be inaccurate depending on when it was last updated.
     - Placeholder for Māori freehold land – [To be determined after the session on Māori assets].

7. The existing rules already require valuation of shares in a number of situations. Two methods which are already established are:

   - Volume weighted average price (VWAP)[3] – this would smooth out temporary fluctuations in asset value immediately before Valuation Day.
   - Recent transactions – this may be suitable when there has been a comparable transaction within a recent period such as six months.

8. Property that is already revenue account property[4] will not need to be valued on Valuation Day as this property is already subject to tax on sale so values are already held.

9. Default valuation options could be set for each kind of asset. These would operate as a backstop to all the other options for taxpayers who might not want to consider a range of options.

Median rule

10. The Group proposes that a median rule should be applied to all affected assets, except for listed shares, to calculate the eventual gain or loss when an asset is realised. Using the median rule, the amount to be deducted from the sale price would be the median of:

    - the actual cost, including costs incurred both before and after Valuation Day;
    - the value on Valuation Day, plus costs incurred after Valuation Day; and
    - the sale price

11. The median rule will smooth capital income to prevent taxpayers being subject to tax on artificial paper gains (or losses) that arise only due to the value on Valuation Day being lower (or higher) than the cost price and the sale price.

---

[3] VWAP calculates the average price of an asset based on all sales over a set period, such as five days. This is weighted by the size of the trades so that a large trade has a bigger impact on the average price than a smaller trade at the same price.

[4] Revenue account property is defined in the Income Tax Act 2007, as property that:

- is trading stock; or
- if disposed of for valuable consideration, would give rise to income for the person under the Income Tax Act (with some exceptions).

Example 1 – median rule

In 2014 Ben bought a rental property for $500,000. He hired a registered valuer to establish the market value of his property on Valuation Day. The valuer said the property was worth $650,000. Ben sold the property two years after Valuation Day for $800,000.

Applying the median rule:

Cost = $500,000

Valuation Day = $650,000

Sale price = $800,000

The median value is $650,000. Therefore, Ben is able to deduct $650,000 from the sale price of $800,000, giving rise to a $150,000 taxable gain.

Example 2 – median rule with cost incurred before Valuation Day

In 2014 Ben bought a rental property for $500,000. He spent $50,000 installing a new kitchen, and adding an extra bedroom. On Valuation Day the property was worth $450,000. Ben sold the property two years after Valuation Day for $900,000.

Applying the median rule:

Cost = $500,000 plus the $50,000 in capital costs incurred

Valuation Day = $450,000

Sale price = $900,000

The median value is $550,000. Therefore, Ben is able to deduct $550,000 from the sale price of $900,000, giving rise to a $350,000 taxable gain.

12. The Group proposes that the requirement to determine a value on Valuation Day under the median rule is included in legislation and that Inland Revenue issues guidance on appropriate valuation methods.

Valuing the family home at a change-in-use date

13. As discussed above, the Group proposes that a valuation will be required where a house changes use from an “excluded home” to an income earning use, or vice versa. When there is a single change of use the median rule would apply.

Example 1 – house ceasing to be an excluded home

In 2018 Chris buys a house for $500,000 which he lives in. On 1 April 2023 Chris buys a second house which he moves into and rents out his first house which now has a value of $750,000. On 31 March 2025 Chris sells the first house for $800,000.

Applying the median rule:

Cost = $500,000

Valuation on 1 April 2023 = $750,000

Sale price = $800,000

The median value is $750,000. Therefore, Chris is able to deduct $750,000 from the sale price of $800,000, giving rise to a $50,000 taxable gain.

14. Where a house changes to an excluded home the median rule can also be used to determine the deemed sale price. This will mean any gain on the deemed sale will be capped at the overall gain on the sale including the period it was an "excluded home".

Example 2 – house becomes an excluded home

On 1 April 2021 Lucy buys a rental property for $500,000. On 1 April 2023 Lucy moves into the property and it becomes an excluded home. At this date the property is valued at $750,000. Lucy sells the property for $600,000 on 31 March 2025

Applying the median rule:

Cost = $500,000

Valuation on 1 April 2023 = $750,000

Sale price = $600,000

The median value, to determine the deemed sale price, is $600,000. Lucy is able to deduct $500,000 from the deemed sale price of $600,000, giving rise to a $100,000 taxable gain. Without the median rule Lucy would have had a $250,000 taxable gain even though she sold the house for only $100,000 more than she paid for it.

15. Where more than one valuation is needed, such as when a property is subject to two (or more) changes of use, the median rule cannot easily be applied as there are now more than three values and the relevant three to consider depend on their relative size.

16. Instead a limiting rule would apply. This would work as follows:

- A person is taxable on any change in the valuations during the period the property was not an "excluded home"; however:
    - Gains during the period the property was not an "excluded home" cannot exceed total gains over the period the property is owned.
    - Losses during the period the property was not an "excluded home" cannot exceed total losses over the period the property is owned.

Example 3 – house changes use twice

On 1 April 2021 Neil buys a house to live in for $500,000. On 1 April 2023 Neil moves to New York for a two-year sabbatical and rents his house out while he is away. His house is valued at $600,000.

On 31 March 2025 Neil returns to live in his house which is now valued at $580,000. Neil eventually sells his house on 31 March 2030 for $800,000.

Applying the median rule:

Cost = $500,000

Valuation on 1 April 2023 = $600,000

Valuation on 1 April 2025 = $580,000

Sale price = $800,000

During the period the house was not an excluded home it decreased in value by $20,000. However, during the whole period of ownership the house increased in value by $300,000 therefore no taxable loss is available.

Appendix B: Commissioner's Statement CS 17/01

Determining "value" of shares received by an employee under a share purchase agreement

The purpose of a Commissioner's Statement is to inform taxpayers of the Commissioner's position and the operational approach being adopted on a particular tax matter. A Commissioner's Statement is not a consultative document.

All legislative references are to the Income Tax Act 2007 ("the Act").

Introduction

1. Changes to the Income Tax Act 2007, which came into force on 1 April 2017,[5] introduce new reporting rules for employers when shares are issued[6] to employees pursuant to a share purchase agreement ("SPA").

2. The new reporting rules require employers to report the value of any share benefit received by an employee under an SPA in the relevant employer monthly schedule ("EMS") for which the share benefit arises. In addition, the new rules also allow employers to elect to withhold PAYE on share benefits received by employees.

3. In order to comply with the new obligations, an employer will need to determine the **value of the share benefit** received by each employee under an SPA.

4. Having regard to the requirements of the law, valuation uncertainties and employer compliance costs, the Commissioner will accept the methods of valuation set out in this Statement provided that the SPA is conducted on arm's length commercial terms.

5. While this Statement provides taxpayers with safe harbour valuation methodologies which the Commissioner will accept, this Statement will not apply to any arrangements which are subject to any anti-avoidance provisions in the Act.

6. This Statement also provides guidance in regard to the information the company3[7] should retain to support the valuation (in addition to any constitutional and Companies Act 1993 requirements).

7. This guidance relates to the new provisions and any other aspects of the current provisions relating to the valuation of shares acquired by an employee under an SPA.

[5] The Taxation (Transformation: First Phase Simplification and Other Measures) Act 2016.

[6] Note that the phrase "shares are issued" refers to shares (or rights to shares) which are issued or transferred to an employee.

[7] Please note that "company" refers to the employing company even if the shares in question are issued or transferred to the employee by another entity.

8. This Statement is not intended to provide a definitive and comprehensive set of valuation techniques, and so companies may still apply other valuation methodologies that determine the value of the share benefit. If another valuation methodology is used by a company, the valuation must reflect the market value of the shares on the acquisition date.

Employment Income

9. Benefits received by an employee under an SPA are employment income.

10. An SPA is defined in section CE 7 of the Act as:

> …an agreement to dispose of or issue shares in a company to an employee that is entered into in connection with the employee's employment or service, whether or not an employment relationship exists when the employee receives a benefit under the agreement.

11. An SPA involves the acquisition of shares in a company by an employee (or another person for the benefit of an employee). These cover a wide range of share schemes and may involve the immediate transfer of shares, the granting of share options or deferred share schemes where shares vest or are transferred at a later date.

12. A taxable share benefit arises when an employee acquires shares under an SPA and the amount paid by the employee for the shares is less than the market value of the shares.

13. Section CE 2 of the Act determines the value of the benefit the employee receives and the allocation of the benefit to a particular year.

14. Section CE 6 of the Act outlines when shares are acquired by an employee ("acquisition date") under an SPA.

15. Section CE 6(2) provides that, for the purposes of sections CE 2 to CE 4 and CE 7:

> (a) shares are treated as having been acquired on the date on which the right or option to acquire them is exercised; and
>
> (b) if shares or rights are acquired or transferred under an agreement by a trustee for the benefit of an employee to whom section CE 2 applies, the employee is treated as having acquired or transferred the shares or rights.

16. The obligation to report the value of a share benefit and the election to withhold PAYE is limited to share benefits arising under sections CE 2(2) and CE 2(4) of the Act.

17. Section CE 2(2) relates to shares acquired by an employee under an SPA:

> If an employee acquires shares under a share purchase agreement, the value of the benefit to the employee is the amount by which the value of the shares when they were acquired is more than the amount paid or payable for them. The employee receives the benefit in the income year in which they acquire the shares.

18. Section CE 2(4) relates to shares acquired by an associated person of the employee under an SPA:

> If, following 1 or more transactions between associated persons, an associated person acquires the shares under a share purchase agreement, the value of the benefit is the difference between the value of the shares on the date of acquisition by the associated person and the amount paid or payable for them. If the difference is negative, the value is zero. The employee receives the benefit in the income year in which the associated person acquires the shares.

Value of Share Benefit

19. In order to determine the value of the share benefit arising for an employee or associated person, an employer will need to determine the following:

- The value of shares on acquisition date; and
- The amount paid or payable for them.

20. The Act does not define "value", nor does it prescribe any methods for determining the value of shares acquired under an SPA.

21. The Commissioner considers the term "value" for the purpose of section CE 2 refers to the market value amount at which the shares would be exchanged between two non-associated third parties, on an arm's length basis. This value is required to be determined even if the shares cannot be sold or there is no market for the shares.

22. For completeness, the definition of "market value" in section YA 1 does not apply to this Statement.

Acceptable Valuation Methods

23. Where the company adopts one of the methods outlined in this Statement and retains the necessary documentation to support the valuation, the Commissioner will accept the share value and therefore the benefit ascribed to the employee under section CE 2.

24. Absolute accuracy is not expected in all scenarios (as accuracy depends in part to the data sets available and in some situations on subjective judgement), but it is expected that a reasonable, appropriate process is followed when determining the share value at the time the shares are issued.

25. It is also expected that the valuation method and any input assumptions used to prepare the valuation should be fully documented and retained as the Commissioner may request to examine the documentation.

26. Where a company adopts a method not outlined in this Statement, the company should retain the documentation outlining the reasons for adopting the alternative method as the Commissioner may request to examine the documentation.

27. The methods which the Commissioner will accept will depend on the type of shares issued to the employee under an SPA – shares in a listed company; shares in an unlisted company; or shares in an unlisted start-up company.

28. Outlined below are the methods the Commissioner will accept for the three types of shares.

Listed Shares

29. Where the company issuing shares to an employee has shares listed on a "recognised exchange" the Commissioner will accept the share value reached (applicable to the class of shares, and any rights attaching to them, to which an SPA applies) using one of the following methods:

- **Option A:** Volume weighted average price ("VWAP") over the last five trading days (including the acquisition date) for the listed share; or
- **Option B:** Closing Price of listed share on the acquisition date; or
- **Option C:** If on the acquisition date the employee disposes of the shares at market value on a recognised exchange, the actual proceeds of sale on that date and, if the proceeds of sale are in a foreign currency, the New Zealand Dollar equivalent by applying the close of trading spot price exchange rate on the sale date.

<u>*Recognised Exchange*</u>

30. A recognised exchange is defined in section YA 1.

31. Outlined below are the relevant factors included in the section YA 1 definition:

- A recognised exchange market in New Zealand or anywhere else in the world which has the following features:
    - the exchange market brings together buyers and sellers of shares or options over shares; and
    - the exchange market involves the listing of prices, whether by electronic media or other means, at which persons are willing to buy or sell shares or options; and
    - the exchange market provides a medium for the determination of arm's length prices likely to prove fair and reasonable, having regard to—
        - the number of participants in the market or having access to the market; and
        - the frequency of trading in the market; and
        - the nature of trading in the market, including how prices are determined and transactions are effected; and

- the potential or demonstrated capacity of a person or persons significantly to influence the market; and
- any significant barriers to entry to the market; and
- any discrimination on the basis of quantity bought and sold unless based on the risks involved, the transaction costs, or economies of scale

Volume Weighted Average Price ("VWAP")

32. The VWAP for a share is calculated by adding up the dollars traded for every transaction relating to that share (price multiplied by number of shares traded) and then dividing by the total shares traded for the day.

Example: VWAP for ABC Limited over a 5 day trading period.

Company ABC's shares are traded on the NZX. ABC Ltd issues shares to its employees on Friday 13 January.

Based on information obtained from the NZX, the following ABC shares were traded over the previous five trading days (including the acquisition date) - Monday 9 January to Friday 13 January:

Date	*Number of Shares*	*Volume Weighted Daily Price*
9 January	*5,000*	*$2.00*
10 January	*Nil*	*n/a*
11 January	*4,000*	*$1.98*
12 January	*10,000*	*$2.05*
13 January	*Nil*	*n/a*

The VWAP is calculated as follows:

$$\frac{(5{,}000 \text{ x } \$2.00) + (4{,}000 \text{ x } \$1.98) + (10{,}000 \text{ x } \$2.05)}{19{,}000}$$

= $2.02

The value of the shares issued to ABC's employees on 13 January is $2.02.

Foreign Listed Shares

33. If the shares are not listed in New Zealand but are listed on one or more overseas recognised exchanges, the foreign value determined in accordance with the above options will need to be converted to its New Zealand Dollar equivalent by applying the close of trading spot exchange rate on the acquisition date of the shares by the employee.

34. If the shares are listed on more than one recognised exchange (including for an employee not resident in New Zealand or dually resident here, a recognised exchange in the employee's normal country of residence) the listed price should

be based firstly on the recognised exchanges in the employee's country of residence, or, if that is not applicable, on the average of all the listed prices as converted to New Zealand dollars.

Newly Listed Company

35. Shares issued to employees as part of an initial public offering ("IPO") by a newly listed company should be valued using the published offer price for the IPO.

36. The published offer price is the price included in the retail offer documentation. If the shares are only offered to non-retail investors (e.g. institutional buyers, fund managers) the volume weighted average purchase price of the investors should be utilised pursuant to the relevant offer documentation.

37. If there has been no arm's length trading of the newly listed shares, the published offer price can be used for shares issued to employees after the date of the IPO for a period not exceeding six months (unless there are material changes to the assumptions used to calculate the offer price).

Information Requirements

38. The company should retain information that can support the share value and method, being able to supply the relevant documentation to the Commissioner on request. The following information should be retained:

- If Option A is used, VWAP calculation and supporting listed price data; or
- If Option B is used, closing market listed price data; or
- If Option C is used, documents evidencing the sale and currency conversion and, where an independent third party undertakes the sale and any subsequent conversion of the proceeds to New Zealand Dollars, that third party's advice of the New Zealand Dollar equivalent of the transaction will suffice; or
- If newly listed shares, published offer price; or
- If foreign listed shares, relevant offer or listed price data and the spot FX rate used.

Unlisted Shares

39. Where the company issuing shares to an employee has unlisted shares (not including a start-up company which is defined for the purposes of this guidance below) the Commissioner will accept the share value reached (applicable to the class of shares, and any rights attaching to them, to which an SPA applies) using one of the following methods:

- **Option A:** An arm's length value determined by an independent, suitably qualified valuer which conforms with generally accepted practice[8]; or
- **Option B:** A valuation (based on the company's most recent arm's length commercial transaction in the last six months prior to the acquisition date) involving the issue or sale of the same class of shares to a non-associated third party (for example, a previous capital raising or sale of a parcel of shares) where, if new shares are being issued to employees the valuation is adjusted for dilution of existing shares; or
- **Option C:** A valuation method prepared by an appropriate person in the company using an appropriate method (this option and the requirements to use this option is explained further below).

Dilution Effect When Issuing New Shares

40. All methods should take into account the diluting effect of issuing new shares to employees, particularly if using Option B.

    Example: Company A has previously issued 1m shares to non-associated third parties for $1m. Subsequently, Company A issues 100,000 new shares to employees for no consideration. The value of the shares will be calculated as follows:

    Total consideration paid for shares issued $1m / total shares issued 1.1m = $0.91 per share.

Foreign Company

41. If the unlisted shares are held in a foreign company, the foreign value determined in accordance with the above options will need to be converted to its New Zealand Dollar equivalent by applying the close of trading spot exchange rate on the acquisition date of the shares by the employee.

Previous Valuation

42. The Commissioner will accept a value based on the most recent valuation prepared by a company using option A, B or C if:

    - The valuation is for the same class of shares as the shares issued to the employee; and
    - The valuation was prepared within a period not exceeding six months prior to the acquisition date of the shares by the employee.

43. This Statement will not apply where a company uses a previous valuation and adjustments are made to the original share value resulting in a lower value

[8] For the purposes of paragraphs 39 and 50, "generally accepted practice" means a valuation prepared under AES-2 (Business Valuation Engagements) issued by CA ANZ or an equivalent valuation engagement standard.

(discounting). This Statement will also not apply where the previous valuation relates to shares of a different class to the shares issued under the SPA.

Information Requirements

44. The company should retain information that can support the share value and method, being able to supply the relevant documentation to the Commissioner on request. The following information should be retained:

45. If Option A is used:

- A copy of the independent valuation report received by the company.

46. If Option B is used:

- Documentation supporting the value of the shares issued or sold to the non-associated third party (for example, copy of sale and purchase agreement or capital raising documentation); and
- Confirmation the shares are of the same class; and
- Approval of the valuation in writing by one member of the Board of Directors or the Chief Financial Officer or the Chief Executive Officer of the company confirming that in their opinion the valuation reflects the market value of the shares issued to the employee at the taxing date.

47. If Option C is used, refer to detailed information requirements below.

Option C: Internally Prepared Valuation Requirements

48. If a valuation is prepared internally by the company, the company should retain all the following information:

- A copy of the internally prepared valuation;
- That the valuation was prepared by a person employed by the company who has the necessary financial skills, qualification and experience to prepare a valuation;
- That the valuation is based on an appropriate method. The Commissioner considers the following methods are appropriate methods:
    - Discounted Cash Flow (DCF); or
    - Capitalisation of Earnings;
- Contemporaneous documentation supporting all workings, input assumptions and comparable data used to prepare the valuation. This should include the following information (where applicable):
    - Financial information used to determine earnings (for capitalisation of earnings method) or future cash flows (for DCF method), including (but not limited to):

    - prior year financial statements;
    - current operating results;
    - cash flows and future oriented financial information such as budgets, forecasts and projections;
  - Documentation supporting any normalising adjustments;
  - Documentation supporting discount rates;
  - Documentation supporting capitalisation rates or earnings multiples (including any comparable data used to determine earnings multiples);
  - Reasoning and support for any discounts or premiums;
- That the valuation has been approved in writing by one member of the Board of Directors or the Chief Financial Officer or the Chief Executive Officer of the company confirming that in their opinion the valuation reflects the market value of the shares issued to the employee on the acquisition date or alternatively, that the valuation has been reviewed and agreed with by an independent, suitably qualified valuer appointed or instructed by the Board of Directors;
- A copy of the independent valuation opinion (if applicable).

Shares in an Unlisted Start-up Company

49. The following approach can be applied where the company issuing shares to an employee is a start-up company. This generally means a company which:

- is in the first stage of its operations; and
- initially financed and operated by founding shareholders or investors; and
- has not paid any dividends; and
- its expenses tend to exceed their revenues and may be yet to produce a profit; and
- tend to have very low net tangible assets; and
- may have a high level of expended research and development costs relative to its tangible assets value; and
- does not yet have a stable market for its product or service.

50. The Commissioner will accept the following methods for valuing start-up company shares:

- **Option A:** An arm's length value determined by an independent, suitably qualified valuer which conforms with generally accepted practice; or
- **Option B:** A valuation (based on the company's most recent arm's length commercial transaction in the last 12 months prior to the acquisition date) involving a share issue or sale of the same class of shares to a non-associated

third party (for example, a previous capital raising or sale of a parcel of shares) where, if new shares are being issued to employees the valuation is adjusted for dilution of existing shares; or

- **Option C:** A valuation method prepared by an appropriate person in the company using an appropriate method (this option and the requirements to use this option is explained further below). Option C will not be available if the company has a previous valuation under Option A or a recent issue/sale of shares under Option B.

Venture Capital Funding

51. Given the complexities associated with share valuations for venture capital funding rounds, this Statement will not apply to a company with a current or proposed (i.e. is intended to take place within six months of acquisition date of shares by employee) venture capital funding round.[9] The company should obtain a separate arm's length valuation for any shares issued to employees under an SPA where venture capital funding is involved.

Previous Valuation

52. The Commissioner will accept a value based on the most recent valuation prepared by a company using option A, B or C if:

    - The valuation is for the same class of shares as the shares issued to the employee; and
    - The valuation was prepared within a period not exceeding 12 months prior to the acquisition date of the shares by the employee.

53. This Statement will not apply where a company uses a previous valuation and adjustments are made to the original share value resulting in a lower value. This Statement will also not apply where the previous valuation relates to shares of a different class to the shares issued under the SPA.

Information Requirements

54. The company should retain information that can support the share value and method, being able to supply the relevant documentation to the Commissioner on request. The following information should be retained:

55. If Option A is used:

    - A copy of the independent valuation report received by the company.

56. If Option B is used:

---

[9] Venture capital funding round means funding by a venture capital fund or firm (including Series A funding rounds). It does not include seed funding from private investors.

- Documentation supporting the value of the shares issued or sold to the non-associated third party (for example, copy of sale and purchase agreement or capital raising documentation); and
- Confirmation that the shares sold to the non-associated third party are of the same class as SPA shares and have the same rights attached to them; and
- Approval of the valuation in writing by one member of the Board of Directors or the Chief Financial Officer or the Chief Executive Officer of the company confirming that in their opinion the valuation reflects the market value of the shares issued to the employee at the taxing date.

57. If Option C is used, refer to detailed information requirements below.

Option C: Internally Prepared Valuation Requirements

58. If a valuation is prepared internally by the company, the company should retain all the following information:

- A copy of the internally prepared valuation;
- That the valuation was prepared by a person employed by the company who has the necessary financial skills, qualification and experience to prepare a valuation;
- That the valuation is based on an appropriate method. The Commissioner considers the following methods are appropriate methods:
  - Discounted Cash Flow (DCF);
- Contemporaneous documentation supporting all workings, input assumptions and comparable data used to prepare the valuation. This should include the following information (where applicable):
  - Financial information used to determine future cash flows including (but not limited to):
    - prior year financial statements;
    - current operating results;
    - cash flows and future oriented financial information such as budgets, forecasts and projections;
  - Documentation supporting any normalising adjustments;
  - Documentation supporting discount rates;
  - Documentation supporting capitalisation rates;
  - Reasoning and support for any discounts or premiums;
- That the valuation has been approved in writing by one member of the Board of Directors or the Chief Financial Officer or the Chief Executive Officer of the company confirming that in their opinion the valuation reflects the market value of the shares issued to the employee on the acquisition date or

alternatively, that the valuation has been reviewed and agreed with by an independent, suitably qualified valuer appointed or instructed by the Board of Directors;

- A copy of the independent valuation opinion (if applicable).

Application

59. This Statement provides general guidance to assist taxpayers in meeting their tax obligations. This approach can be used by taxpayers for, and will be applied by the Commissioner to, shares acquired by employees on or after 1 April 2017.

60. If you have any concerns about your compliance with the tax obligations discussed in this Statement, you should discuss the matter with an appropriately qualified tax professional.

Graham Tubb
Group Tax Counsel

Date of Issue: 28 April 2017

Appendix C: Other countries

1. This appendix outlines how some other countries addressed value on their Valuation Day.

Canada

2. Taxation of capital gains was introduced in 1972. On Valuation Day, a cost base had to be established for all capital assets. Taxpayers had to use one of the following two methods to determine the cost of their non-depreciable assets for capital gains purposes:

   - fair market value; or
   - the cost under the "median rule".

3. Once a method was chosen to calculate the capital gain or loss resulting from the first disposition of capital property, the same method has to be used for all dispositions of such property.

4. The median rule set out that the cost of an assets was the middle figure of:

   - proceeds of disposition;
   - Valuation Day value; and
   - actual original cost.

5. For publicly traded stock, a list was published of the closing stock prices on the day before the tax was introduced. An individual holding publicly traded stock could choose to use that price, or the median rule, but if they chose the actual price method, they had to use it for all their publicly traded securities.

Ireland

6. Taxation of capital gains was introduced in 1974. A "market value" rule was used. The basic rule underlying this was that the market value was the price which an asset might reasonably be expected to fetch on a sale on the open market.

7. The cost base for shares owned prior to Valuation Day was the price quoted on the stock exchange.

8. There is case law to help guide what is meant by "market value". The principles from the case law are as follows:

   - The expected sale price is the price agreed on by persons aware of all relevant details.
   - In determining the value any reluctance of owner to part with the asset on that date should be disregarded.

- Open market includes all potential purchasers.

9. A "Valuation Guide" was created to provide guidance on possible methods/considerations to value unlisted shares based on:

   - earnings;
   - assets;
   - turnover fees or commissions;
   - control of a company; and
   - different classes of shares.

South Africa

10. Taxation of capital gains was introduced in 2001. In order to ensure the part of the gain or loss which related to the period before the tax was introduced was excluded, a value had to be determined for the asset as at the date the tax was introduced.

11. Taxpayers could use one of the following methods to determine the valuation date value of the asset:

    - 20% × (proceeds less allowable expenditure incurred on or after 1 October 2001). This method would typically be used when no records have been kept and no valuation was obtained at 1 October 2001.
    - Market value of the asset as at 1 October 2001. In order to use this method the person must have valued their asset on or before 30 September 2004 except in the case of certain assets whose prices were published in the *Government Gazette*, such as South African-listed shares or participatory interests in collective investment schemes.
    - Time-apportionment base cost method. This is a method of calculating the value of the asset based on how long the person has owned it before, and on or after 1 October 2001.

12. For unlisted shares a "Tax Guide for Share Owners" was created to assist in determining the base cost of shares acquired before 1 October 2001 (Valuation Day), based on:

    - the market value on Valuation Day;
    - time apportionment; or
    - 20% of proceeds after first deducting post-CGT costs.

13. The market value is the price a willing buyer would pay a willing seller if dealing at arm's length in the open market. Case law has provided suggestions of methods that can be used to determine the "market value" including:

- net asset value method;
- income approach, which seeks to estimate the flow of revenue that the company will generate in the future; and
- the discounted cash-flow method, which entails valuing the business in question on the basis of its forecast future cash flow, discounted back to present-day values through the application of a discount factor.