

Employee share plans in interesting times

By **Gary Fitton**, Director, Remuneration Strategies Group

Recently, the company secretary of a large listed company sought urgent assistance regarding participants in their employee share plan. Employees were proposing to self-assess for income tax on the exercise of their performance rights, issued to them by the company as a part of a key employee, long-term incentive program.

The employees had lodged notices of exercise of the performance rights in September 2008, when the shares were valued at \$4 at the peak of a long-running ASX boom, instead of the \$1.50, the ASX market value to which the shares had fallen, during the operation of the rights' sales restrictive period.

The employees proposed to mortgage houses to borrow tens of thousands of dollars to pay income tax on share benefits that were to be included as ordinary assessable income in income tax returns for the year ended 30 June 2009.

It was immediately apparent that the design of the plan contravened a basic rule of employee share plans to ensure that the timing of the taxation of the share benefit coincides with the timing of the sale of their shares when the employee has the cash in their hand.

The company secretary sent us the plan documentation by email and asked us to provide some speedy advice on how to rationalise the tax consequences for employees and reduce operating costs for the plans in place.

Our response

A review of the documentation revealed that the employees were about to inadvertently self-assess for income tax at the time of the exercise of the rights (\$4), rather than the occurrence of the 'cessation time', which is when the restrictions on disposal of the shares occurred and the shares are free to be sold (that is, at \$1.50).

Tax advice

A review of the tax advice provided in the employee explanatory handbook revealed it to be very difficult for most employees to comprehend.

The bulk of the advice was taken up with explaining the income tax and capital gains tax (CGT) implications making a s 139E election to be

- *Many employee share plans now effectively worthless because options were issued in 2007 or 2008 at peak of boom*
- *Potential tax benefits for employees of companies, plus the companies themselves, using employee share trusts instead of performance rights*
- *Very important to appoint specialist plan manager to provide advice when required*

taxed up-front, which, given that the employees were being provided with full value performance rights issued at the peak of the boom, would have been a very unwise choice indeed.

The tax advice was far too technical to communicate taxation consequences clearly to the employees and also incorrect in certain other key respects.

Furthermore, the employees had no access to a plan manager to seek ready clarification of the taxation consequences of their participation in the performance rights plan.

Recommended course of action

We recommended, in the short term that employees needed to reconsider their tax positions so as to ensure that their share benefits would be assessed for income tax at the reduced share value of \$1.50 per share, as at the relevant 'cessation time' when the shares are free to be sold.

Over the long term, we recommended that the company consider winding up the performance rights plan and to provide future allocations of equity to selected key employees nominated by the board of the company under a loan-based employee share trust (EST).

The loan-based EST had the important taxation attributes of:



- full tax deductibility for contributions by the employer to the EST
- no confusing s 139E up-front taxing decisions for the employees
- tax deferral until sale of shares by employees and
- upon sale of the shares, the issue price will be taxed as ordinary income and the growth in the value of the shares will be taxed as concessional CGT (provided the employee held the units for the mandatory 12-month period).

We also recommended that the company consider introduction of a tax exempt share plan, falling under the provisions of s 139BA. Under this plan, annual ongoing offers of up to \$1,000 worth of tax exempt shares under that plan would be made to all permanent employees, on a fully vested, salary sacrifice basis.

What is an employee share option?

An option is a contractual right to purchase a share (a call option) or sell a share (a put option) at a stated exercise price. Employee share options are usually call options, with an exercise price typically set at the market value of the subject shares at the date of issue of the options. Options do not entitle holders to receive dividends or vote at shareholder meetings.

However, they can have the exercise price set at a discount or a premium to the market price prevailing at the time of issue of the options.

Employee share options usually have a life of five years and are often subject to a vesting period (usually three years) and performance hurdles — usually linked to total shareholder return (TSR) — but may be related to more internally based cost savings or productivity measures, given the current generally recessed market share price conditions. Recessed market conditions are also conducive to some companies discounting option exercise pricing, to bolster their effectiveness in bear market conditions.

Employee share options are usually not transferable and cannot be traded by employees. Importantly, for companies wishing to divert cash resources to capital project investments, unlike salaries, there is no net cash outflow at the time of the grant of the options.

What is an employee performance right?

A performance right is similar to a call options in that they are simply a contingent right to acquire a share in the future. Like options, performance rights do not pay dividends or extend shareholder voting rights.

Most performance rights operate like a zero exercise price option (Zepo — see p 148), in that they provide a benefit based on the full value of the share.

Options out of the money

A recent media report quoted a survey of employee share option plans, which concluded that options issued by the top 50 ASX companies surveyed since 2003 are now worthless, as they are 'out of the money' and 'under water' (that is, that the current share price is less than the exercise price of the option). The study also showed that, of the bottom two-thirds of the companies listed in the S&P/ASX 300 Index, almost 90 per cent of options issued since 2003 were also out of the money and worthless.²

Other surveys from overseas show similar results, but also demonstrate that options issued in 2007 and 2008, with exercise prices set at the peak of the boom, will have an even greater likelihood of being 'out of the money'.

Of course, the critical question is what can companies do about equity allocations made over the past five years, given that options, performance rights and shares have become a large part of remuneration packages at all levels.

The expensing of employee equity

Changes in accounting standards, ASX Listing Rules and corporate law have meant that employees' total remuneration and equity-based benefits must now be properly valued, that value communicated to participants, fully disclosed to 'stakeholders' and expensed in companies' annual accounts.

In particular, the introduction of accounting standard AASB2 for share-based payments, which was generally operational as of 1 January 2005, with its antecedents in the US-based Generally Accepted Accounting Principles (GAAP) and UK-based International Accounting Standards Board, has created a sound basis of integrated and coherent valuation principles for a range of employee and executive equity delivery methodologies.

This has meant that any options, performance rights and shares allocated to employees issued since 1 January 2005 must be valued at the date of issue and expensed in the revenue accounts of the organisation. However, given the dramatic fall in share values since October 2008, many of those allocations may have resulted in overstated AASB2 share-based payment amounts being expensed in the annual corporate revenue accounts.

Under AASB2, the previously issued equity would need to be revalued at the date of cancellation and set-off against the expense of any replacement employee equity allocations, albeit at the lower valuation levels.

It should go without saying that any employee and executive share plan arrangements should not only be optimal for the employees and executives concerned, but for the company, its shareholders and other stakeholders.

Employer contributions deductible

Also importantly, like paying salary, provided an interposed plan trustee is introduced to acquire and deliver the shares to the employees, the company may obtain an income tax deduction for irretrievable contributions made to enable that plan trustee to acquire options, rights and shares to be provided to its employees.³

The options are usually issued at a value determined under a Black Scholes Merton valuation in line with accounting standard AASB2. The level of the contributions would enable the trustee to acquire the options at their AASB2 valuation.

Special incentive measures

Depressed share prices and earnings can disrupt companies' incentive-based equity plans. Many companies are considering special measures to maintain the effectiveness of their incentive measures to retain key employees and boost morale.

In contrast to previous downturns, a greater percentage of long-term equity based incentives have been linked to fixed-base TSR return contingencies (for example, ranging from nine to 15 per cent over a three-year vesting period). These fixed TSR returns may be quite achievable in ordinary market conditions, but unrealistic in the current market.

Some companies are considering new performance hurdle measures based on net debt targets, pre-tax profitability and TSR matched to a selection of comparable companies rather than a fixed-base TSR contingency.

Other companies intend to offer full value equity as Zepos, performance rights or restricted shares.

Some companies propose to cancel and replace 'out of the money' options with options at current lower market-based exercise prices. As mentioned earlier, this will also have the effect of reversing the previous higher expensing values for the 'under water' options and replacing them with the lower expensing values for options with the currently reduced option exercise price to give their options more 'bite' as a long-term incentive. This will have a net positive effect on the companies' current revenue accounts.

However, there has also been a recent trend for companies to make regular annual allocations of options that will automatically replace the 'out of the money' options by the annual issue of fresh options, with exercise prices at the lower share values. Those options that are under water at the time of exercise

will usually lapse unexercised as a part of the natural attrition of ineffective option allocations inherent in the regular allocation of options.

Increased demand for expertise

The trend to integrate employee equity into the incentive-based remuneration strategies of companies, combined with new legislative, regulatory and financial reporting obligations, has caused a dramatic increase in the demand for expertise in the market for employee share plan management, administration and related consulting services.

Plan manager

Given the specialist nature of the employee share plan administration services, it is quite common for employers and plan trustees to appoint specialist plan managers.

The plan manager's role goes well beyond simple administration. A simple administration service will only record the price the shares acquired or sold. Companies and their employees require much more information and ongoing support.

The plan manager must be able to design and maintain effective communication methodologies that convey the necessary tax accounting and legal advice for the employer, the plan trustee and participating employees.

The plan manager must also keep abreast of any tax or other legislative changes and inform the company and participants on developments that impinge on the plans it manages. That advice should be ongoing and readily accessible by email and telephone. Binding tax rulings should be sought from the ATO to support all plan implementations.

Typical employee share option and performance right scenarios

Option or right valuation

Any shares, rights or options proposed to be offered to employees would need to be valued and expensed under the relevant accounting standard, being AASB2, under a Black Scholes Merton methodology.

Growth-only options or rights

Utilising the RSG equity-based remuneration calculator, each growth-only or geared option would be valued at 75 cents.

This valuation is based on the following assumptions:

- a share price of \$4
- a 'strike' or exercise price of \$4
- a call life of five years
- a vesting period of three years
- a risk-free interest rate for the company of 3.25 per cent
- a lost dividend yield of 5.5 per cent

- a volatility factor of 30 per cent and
- annual staff turnover of five per cent.

For the gross remuneration cost of \$200,000, the employee would receive 266,666 growth-only options.

Growth in share value

As the options are often issued with an exercise price at the prevailing market value of the shares, the only basis for providing a benefit under this arrangement is from the growth in the share value, over the period the options are held unexercised by the employee. This is referred to in colloquial, general business usage, as a 'growth-only' benefit.

Zepos and performance rights

We have also valued Zepos or performance rights as alternatives to be considered in contrast to the growth-only options. The value of the Zepos or performance rights, utilising the RSG equity-based remuneration calculator, will be \$3.41 per option.

These valuations utilise the same assumptions as the growth-only options except, of course, the 'strike' or exercise price will be zero.

For the gross remuneration cost of \$200,000, the employee would receive 58,651 Zepos.

Discount equity

Any equity provided at a discount may be immediately assessable to the employee under the provisions of Div 13A of ITAA 1936 and raises many complex taxation issues for both the employer and employees.

The main issue for the employee being whether they should lodge a s 139E election to be taxed upfront.

The issues for the employer include, whether:

- the equity to be offered is in respect to ordinary shares of the employer
- any employee will hold more than five per cent of the issued shares
- the equity should be issued with restrictions on disposal and/or subject to forfeiture
- offers are being made to at least 75 per cent of all permanent employees and
- the offers are to be made to non-employee contract labour.

Market value equity

However, if the equity is provided at market value under a properly designed EST and the employee is provided with an interest-free loan to acquire the equity, the employee will not be assessable upfront, there will be no confusing s 139E decisions and they will create a CGT cost base for the value of the equity acquired.

Plan design alternatives

Basically, the sponsoring company must decide between two alternatives on the plan design to

best deliver the equity offered to the participating employees.

Alternative 1: Growth-only option with s 139E election

The s 139E election to be taxed up-front on the growth-only option will have a taxable discount of 11.6 per cent of the \$4 market value of the share⁴, being 46.4 cents per option.

The employee will pay 21.6 cents per option income tax (assuming a 46.5 per cent marginal income tax rate), and will establish a CGT cost base of 46.4 cents per option.

In this case, with 266,666 growth-only options proposed to be issued, the upfront income tax would amount to \$57,536, which, if the options were under water, the employees could only retrieve (with interest) from the ATO upon cancellation of the options or at the end of the five-year option life. Short of mortgaging the family home, most employees (including executives) are highly unlikely to have ready access to that amount of money.

Therefore, in line with our experience as consultants in this area, the employees should not make the s 139E election.

Zepos

If the employee were to make a s 139E election on the acquisition of the Zepo, the taxable discount for s 139FC purposes will be the full market value of the share (\$4). Consequently, had the employee elected to pay tax on the acquisition of the options, they will be liable for income tax of \$1.86 per option up-front and will have a CGT cost base of \$4 per option.

As the employee is offered 58,651 options (that is, 200,000 divided by the Zepo price of \$3.41), they would be liable for a total of \$125,513 income tax on the acquisition of the options. Again, the employees would simply be unable to fund the income tax and, consequently, should not make the s 139E election.

Interestingly, Zepo-based option and performance rights valuations are one of the few occasions that the Division 13A valuation for tax purposes will be greater than the accounting valuation for AASB2 purposes. This is because the Div13A valuation does not factor in the cost of the options not being able to pay dividends. To that extent, the Div 13A valuation overstates the value of the option for tax purposes at acquisition.

Alternative 2: Loan-based employee share trust

Many companies have provided the rights to shares by way of an interposed EST.

The role of the EST is to act as:

- the recipient of funds
- the warehouse for the shares

- the plan administrator who allocates shares to participating employees according to the plan deed and
- the market for shares, a critical role for unlisted company shares.

The plan trustee can also provide loan funding to employees to acquire shares and rights to shares, without needing to access their own financial resources.

Under this scenario, the employee will obtain an interest-free loan to acquire share units (rights to shares) from the plan trustee at their arm's length value determined under AASB2. The plan trustee will acquire shares or performance rights or call options from the company at AASB2 values and allocate the equity to the share units to be issued to employees, to ensure that the plan trustee (and the sponsoring company) is protected against any increase in share value over the vesting period.

There is no s 139E election required, as there is no up-front taxable discount. Consequently, the employee is not liable to pay tax on the acquisition of the options and will have a CGT cost base of \$3.41 per share unit based on the value of the options.

Furthermore, offers can be made to non-employee contract service providers, without jeopardising the general tax effectiveness of the plan.

Conclusion

There would seem little doubt that the loan-based EST is the optimal equity delivery vehicle for companies intending to offer equity allocations to

their staff in excess of \$1,000 per annum and with service- and performance-based conditions.

For offers of equity involving offers of ordinary shares of the company to more than 75 per cent of the company's employees, of a value less than \$1,000 per annum, on an egalitarian and fully vested basis, a tax-exempt plan should also be considered.

The company I mentioned at the start accepted both recommendations. This entailed cancelling the existing performance right allocation and implementing a new tax-exempt share plan.

Fortunately, under s 139DD of ITAA 1936, the earlier performance rights allocations were able to be cancelled, without any tax consequences for the company or participating employees. Under s 139DD the performance rights cancelled are deemed never to have been acquired by the employee.

The equity was then reissued under the EST, at the lower prevailing market valuations.

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Notes

- 1 See s 139CB(1) *Income Tax Assessment Act 1936* (ITAA 1936)
- 2 Durkin P, 2009, 'Share option plans worthless', *Australian Financial Review*, 16 January 2009, p 4
- 3 See ATO Interpretative Decision ATO ID 2002/1074
- 4 See ss 139FK to 139FM of ITAA 1936 ●

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