GRG Remuneration Review

Shares and Options for Directors

Remuneration Review No 18

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INTRODUCTION

Although the new taxing provisions for Employee Share Schemes (ESSs) have not yet been passed by Parliament, it is expected that there will be little change to the provisions contained in the Exposure Draft which was open to submission from the public until 31 August 2009. The comments in this article are based on the Exposure Draft and therefore may be subject to change.

PAST MARKET PRACTICE

In the past it has been common practice for companies to operate one of two types of equity plans for non-executive directors. These were:

- Fees sacrifice share acquisition plans, and
- Share option plans.

Share options plans were mainly used by companies wishing to preserve cash and/or to align director and shareholder interests in high risk ventures e.g. explorers, and start-up companies.

Fee sacrifice share acquisition plans were mainly used by established companies to facilitate investment by directors in their company's shares in a tax effective manner.

Both of these plans may be continued but on a modified basis as discussed below.

FEE SACRIFICE SHARE ACQUISITION PLANS

Two Plan Types

There will be two alternative plan types that may be used for fee sacrifice share acquisition plans being salary sacrifice and other tax deferred share plans. As both plans involve acquisitions of shares as opposed to rights/options it will be necessary for the "75% offer test" to be satisfied.

The "75% offer test" means that 75% of permanent employees of the employer are, or at some time earlier had been entitled to acquire ESS interests (shares or rights/options) in the employer or a holding company under the scheme or another ESS. It should be noted that the previous definition of "permanent employee" included full time and permanent part time employees with three (3) or more years of service. The new definition has left out the three (3) years service aspect and therefore includes more employees than previously was the case.

Salary Sacrifice Plan

Salary sacrifice plans need to be separate plans that allow employees to sacrifice up to $5,000 of salary to fund the acquisition of shares. Although there need not be any risk of forfeiture (risk would be inconsistent with the concept of salary sacrifice) there will need to be dealing restrictions attached to the shares at the time of acquisition. The time when the dealing restrictions cease to apply will be the time when the value of the shares is taxed as income of the employee/director.

Future use of this plan will most likely be limited due to the annual limit of $5,000 on the amount that may be sacrificed to acquire shares on a tax deferred basis.

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Other Tax Deferred Plans

Tax deferral other than via the salary sacrifice plan will require the shares to be exposed to "real risk of forfeiture". The widely used risk provision under which shares are forfeited in the event of "fraud, defalcation or gross misconduct" by the director will not be regarded as a "real risk of forfeiture". However, vesting after a period of service will be regarded as a real risk of forfeiture.

In the past the acquisitions of shares often took place monthly so as to coincide with the earning of the fees that were being sacrificed to fund the share acquisitions. In these circumstances it would not be reasonable to attach a "real risk of forfeiture" to the shares. However, when shares are acquired in advance a "real risk of forfeiture" may be applied to the shares without materially disadvantaging directors. For example, if three (3) years of share acquisitions were to be acquired in advance then it would not be unreasonable for the shares to vest at the end of the three years. If a director did not serve the full three years then an appropriate level of vesting could occur at the termination and the remainder of the shares could be forfeited.

The advantage of using this plan compared to a salary sacrifice plan is that the amount that may be applied each year to funding share acquisitions need not be limited to $5,000.

Restrict Dealing Until Shares May be Sold

Irrespective of whether a salary sacrifice or other tax deferred plan is used, it will be important to attach a dealing restriction to the shares when they are acquired i.e. via the plan rules or the offer document.

So that employees may realise the value that is being taxed under an ESS at the point in time when it is being taxed it is important for the taxing point to arise at a time when shares may be sold. In this regard the insider trading restrictions of the Corporations Act need to be considered along with any policy that the company may have that also restricts sales of shares to specified periods each year.

Therefore, dealing in vested shares should be restricted at least until the first time when shares in the company may be sold without breaching either the Corporations Act or the company's share trading policy. Longer periods of restriction may be used to further defer the taxing point. However, the maximum tax deferral is until the earlier of: elapse of seven (7) years or termination of employment.

SHARE OPTION PLANS

As options granted to directors generally do not have vesting conditions attached the taxing point will be the time of the grant. If vesting conditions are attached to options then the taxing point is deferred as discussed under "Other Tax Deferred Plans".

Under the Exposure Draft, taxpayers will have a choice in relation to options with terms of up to seven (7) years, to use either:

- the market value of the right, or
- the value determined under provisions contained in the Regulations.

In this regard it should be noted that the Board of Taxation has been asked to review and report on two issues being:

a) how to best determine the market value of employee share scheme benefits; and
b) whether shares and rights under an employee share scheme at a start-up, R&D or speculative focused company should have separate tax deferral arrangements.

The Board of Taxation's final report on these aspects is due by 28 February 2010.

The valuation provisions in the regulations have the outcome of a nil value for unlisted options if the term is no more than six (6) years and the exercise price is no less than 67% higher than the market value of a share at the date of grant. Shorter term options can use lower exercise price premiums and still produce nil values for the options.

This valuation approach allows options with premium exercise prices to be granted to directors without carrying a tax liability for the director until and unless the options are exercised and the shares are sold i.e. no tax until benefit crystallised by sale of the shares.

Thus share option plans remain suitable for use by companies that wish to preserve cash and/or to align director and shareholder interests in high risk ventures e.g. explorers, and start-up companies.

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