GRG Remuneration Review

More on MEPOs

Remuneration Review No 25

November 2010

INTRODUCTION

In the previous GRG Remuneration Review, No. 24 "Issues With Remuneration Options, Rights etc" (copies of previous GRG Remuneration Reviews are available on our website www.godfreyremuneration.com) it was concluded in relation to executive and director remuneration that MEPOs were "generally not suitable for use due to potential for taxation problems". MEPOs are options with an exercise price set at approximately the market share price at the time the options are granted.

The potential tax problems arose from options in some circumstances having taxable values at the taxing point that are greater than the accrued benefit (excess of share price over the exercise price). To illustrate this point it was assumed that a 5 year option with an exercise price of $2.00 vests after 3 years when the share price is $1.95. That option would have a market value of $0.088 (derived from taxation option valuation scale in the Regulations). Thus, if the participant had 1,000,000 options then the taxable value would be $88,000 and tax at 46.5% would be $40,920 (approximately $0.04 per option). A refund of that tax would not be available if the options were not exercised and lapsed at the end of their term. If the share price did not rise to at least $2.04 then the participant would have lost money by having received the options.

It is also important to note that a refund of the tax payable on the options may only be obtained if:

a) the options are exercised and the shares are forfeited, or

b) the options are not exercised and they are forfeited without having been disposed of, and

c) either forfeiture is not the result of:

   a. a choice made by the individual (other than a choice by that individual to cease particular employment), or

   b. a condition of the scheme that has the direct effect of protecting (wholly or partly) the individual against a fall in the market value of the options.

This GRG Remuneration Review was written following receipt of feedback from a director in relation to the prior GRG Remuneration Review. The feedback was that we had been overly dismissive of MEPOs as they could be useful for exploration and other companies having similar potential for rapid share price growth. He advised that the potential taxation problem could be overcome by attaching to MEPOs, vesting conditions that relate to challenging absolute share price growth or total shareholder return (TSR) targets. Thus, when the MEPOs vest the accrued benefit would be significant and greater than the taxable value of the MEPO. He also favoured the use of MEPOs over rights because they raised capital when exercised.

In this GRG Remuneration Review we canvas various terms that may be applied to MEPOs to help identify when they may be appropriate.

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ANALYSIS OF SHARE PRICE VESTING CONDITIONS

We have analysed three sets of MEPOs being those with terms of 3, 4 and 5 years as they are the most frequently used terms for MEPOs. For each set of MEPOs we looked at:

- six sets of compound annual growth rates being: 5%,10%, 15%, 20%, 30% and 50%, and
- up to four performance periods being: 12 months, 24 months, 36 months and 48 months. The remaining term of MEPOs for taxable value calculation purposes is the remainder of the term of the MEPO after the performance period.

The following tables compare the accrued benefit and the taxable value at the end of each performance period. The tables are shaded in:

- grey indicating when the taxable value exceeds the accrued benefit, or
- green indicating when the accrued benefit exceeds the taxable value.

3 Year MEPOs				
Performance Period (Remainder of Option Term)	12 (24)		24 (12)	
Compound Annual Growth Rate in Share Price	Accrued Benefit	Taxable Value	Accrued Benefit	Taxable Value
5%	$0.50	$0.89	$1.03	$1.03
10%	$1.00	$1.27	$2.10	$2.02
15%	$1.50	$1.67	$3.23	$3.01
20%	$2.00	$2.07	$4.40	$4.09
30%	$3.00	$2.87	$6.90	$6.34
50%	$5.00	$4.47	$12.50	$11.38

4 Year MEPOs						
Performance Period (Remainder of Option Term)	12 (36)		24 (24)		36 (12)	
Compound Annual Growth Rate in Share Price	Accrued Benefit	Taxable Value	Accrued Benefit	Taxable Value	Accrued Benefit	Taxable Value
5%	$0.50	$1.04	$1.03	$1.27	$1.58	$1.57
10%	$1.00	$1.41	$2.10	$2.15	$3.31	$3.10
15%	$1.50	$1.81	$3.23	$3.03	$5.21	$4.81
20%	$2.00	$2.21	$4.40	$3.99	$7.28	$6.70
30%	$3.00	$3.01	$6.90	$5.99	$11.97	$10.93
50%	$5.00	$4.61	$12.50	$10.47	$23.75	$21.55

5 Year MEPOs								
Performance Period (Remainder of Option Term)	12 (48)		24 (36)		36 (24)		48 (12)	
Compound Annual Growth Rate in Share Price	Accrued Benefit	Taxable Value	Accrued Benefit	Taxable Value	Accrued Benefit	Taxable Value	Accrued Benefit	Taxable Value
5%	$0.50	$1.29	$1.03	$1.41	$1.58	$1.75	$2.16	$2.11
10%	$1.00	$1.65	$2.10	$2.29	$3.31	$3.11	$4.64	$4.27
15%	$1.50	$2.05	$3.23	$3.17	$5.21	$4.63	$7.49	$6.88
20%	$2.00	$2.45	$4.40	$4.13	$7.28	$6.31	$10.74	$9.76
30%	$3.00	$3.25	$6.90	$6.13	$11.97	$10.07	$18.56	$16.87
50%	$5.00	$4.85	$12.50	$10.61	$23.75	$19.51	$40.63	$36.67

If the accrued benefit exceeds the taxable value then the executive is in a position where he/she may exercise the MEPOs and sell shares to realise the accrued benefit and set aside the tax to be paid. Whether or not they choose to sell shares will, of course, be a personal decision and the individual will be choosing to take the risk of a fall in the share price, if they decide not to sell the shares.

If the taxable value exceeds the accrued benefit then the executive may either exercise the MEPOs and sell the shares or continue to hold the MEPOs or the shares. If the sale of the shares occurs within 30 days of the taxing point then the executive will be taxed on the realised benefit rather than the taxable benefit. Thus, if the accrued benefit is less than the taxable benefit it may be prudent for executives to exercise the MEPOs and sell the shares within 30 days. This tax solution is not without complications as the sale of large numbers of shares by executives may drive down the share price particularly if trading in the shares is thin.

If the executive does not or cannot sell the shares within 30 days of the taxing date then he/she will be potentially disadvantaged unless the accrued benefit increases by future share price growth to an amount equal to or greater than the taxable benefit.

If the shares are sold more than 30 days after the taxing point at less than the total of the taxed value and the amount paid to exercise the MEPOs, then the loss will be a capital loss and may be offset against capital gains but not other income. Thus, if an executive does not have capital gains against which to offset the loss then it will be of little taxation benefit to the executive.

From the shading in the foregoing tables it may be concluded that:

- companies with low share price growth expectations would need to use MEPOs with longer terms and performance measurement periods, and
- companies with high share price growth expectations may use MEPOs with shorter terms and performance measurement periods.

Of course, vesting conditions such as service and strategic milestones may expose executives to the tax problem raised in the previous GRG Remuneration Review. Thus, while MEPOs can be used for executive and director remuneration it may be prudent to only use them with absolute share price growth or TSR vesting conditions.

As a cautionary note companies should be careful when using share price targets without performance periods as such approaches may not be seen as involving a real risk of forfeiture (if not there is no tax deferral) if the share price growth is not seen as challenging given a company's share price history and reasonable share price movement expectations.

Other considerations in relation to using MEPOs are discussed on the next page.

OTHER CONSIDERATIONS

When considering the use of MEPOs, there are other factors that also need to be considered including the following.

1. Once a MEPO vests and any dealing restrictions have ceased to apply the executive will:
    a. have a tax liability that will need to be funded, and
    b. if shares are to be sold the executive will also need to fund the exercise price to convert the MEPOs into shares which in turn will, if it needs to be funded, lead to further sales of shares.

    These factors combined will lead to most, if not all, vested MEPOs being exercised and then sale of the shares. Therefore, the use of MEPOs may not lead to executives becoming long term shareholders in the company.
2. The number of MEPOs that need to be granted to deliver a given value of LTI may, depending upon the value of the MEPOs, give rise to many more MEPOs being granted than would rights if they were used instead. This is often a concern for companies with relatively small numbers of shares on issue and low share prices as the number of MEPOs to be granted can exceed 1% of issued shares per annum which as a general rule is a prudent upper limit.
3. The benefit from MEPOs compared to the benefit from an equivalent value of rights is generally only larger when high rates of share price growth are achieved. Thus, rights are generally considered more appropriate than MEPOs for companies with low to modest share price growth potential.
4. Although not necessarily the only approach that may be adopted, it is common practice for new shares to be issued to option holders when MEPOs are exercised. This approach means that the Company will not obtain a tax deduction for the benefit provided to executives. Accordingly, the net of tax cost of providing MEPOs tends to be higher than the net of tax cost of providing rights as it is common practice for rights plans to be structured so as to generate a tax deduction when vested rights are exercised. The accounting charge for MEPOs and rights does not qualify as a tax deduction.

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