Choosing Between LTI Plans

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Introduction

Recently there has been a re-emergence in the use of Share Purchase Loan Plans (SPLPs) as executive long term incentive (LTI) plans, albeit it on a limited basis. In some cases the use of SPLPs has been driven by the needs of a single executive, often the founder, who already has a significant shareholding in the company and wishes to participate in the executive LTI plan. Tax deferral is only available for grants of options, rights and shares that do not involve loans, when the participant has a beneficial interest in less than 5% of issued shares. Thus, executives who own 5% or more of the issued shares or would do so when a grant of options, rights or shares is taken into account would be taxable on the value of the grant in the year of grant even if vesting conditions were attached to the grant. Using an SPLP enables executives with significant shareholdings to participate in LTI plans without facing tax until the shares are sold. The acquisitions of shares under SPLPs are at no less than the market value of the shares at the time of the acquisition. This means that the acquisition is not an employee share scheme (ESS) acquisition and tax does not arise on the shares until they are sold irrespective of the number of shares held by the participant.

Another attractive aspect of SPLPs is that they are generally taxed under the capital gains tax (CGT) provisions rather than the ESS provisions. An advantage of the CGT provisions is that once shares have been held for more than 12 months, 50% of the capital gain is tax free.

However, whether an SPLP or an options plan or a rights plan is most appropriate for a particular company in relation to most of its executives needs to be determined after consideration of all of the features of the different plans and the circumstances of the company.

Common Plan Design Features

Almost all best practice design features of LTI plans can be accommodated in any of the main types of LTI plans. These features include:

a) Annual grants,
b) Calculation of the number of securities to be offered subject to accurate costing of the securities as discussed later in this GRG Remuneration Insight,
c) Vesting conditions related to performance,
d) Measurement periods of 3 or more years,
e) Retesting of performance over extended measurement periods,
f) Vesting scales related to the level of company performance achieved,
g) Performance gates such as TSR needing to be positive before any vesting occurs,
h) Division of grants into tranches to reflect different vesting conditions and weightings on those vesting conditions,
i) Board discretion to vary vesting to better align vesting with shareholder experiences,

j) Termination of employment provisions for "good leavers" that do not attract tax on unvested securities and do not give rise to termination benefits that exceed the maximum termination benefit that may be provided to managerial and executive officers without shareholder approval of a higher amount,

k) Change of control provisions that provide certainty to executives of minimum vesting yet allow the board discretion for higher vesting, and

l) No issues of shares if grants do not vest, although in the case of SPLPs this is achieved by redeeming and cancelling shares that do not vest.

Traditional Options or Rights/Shares

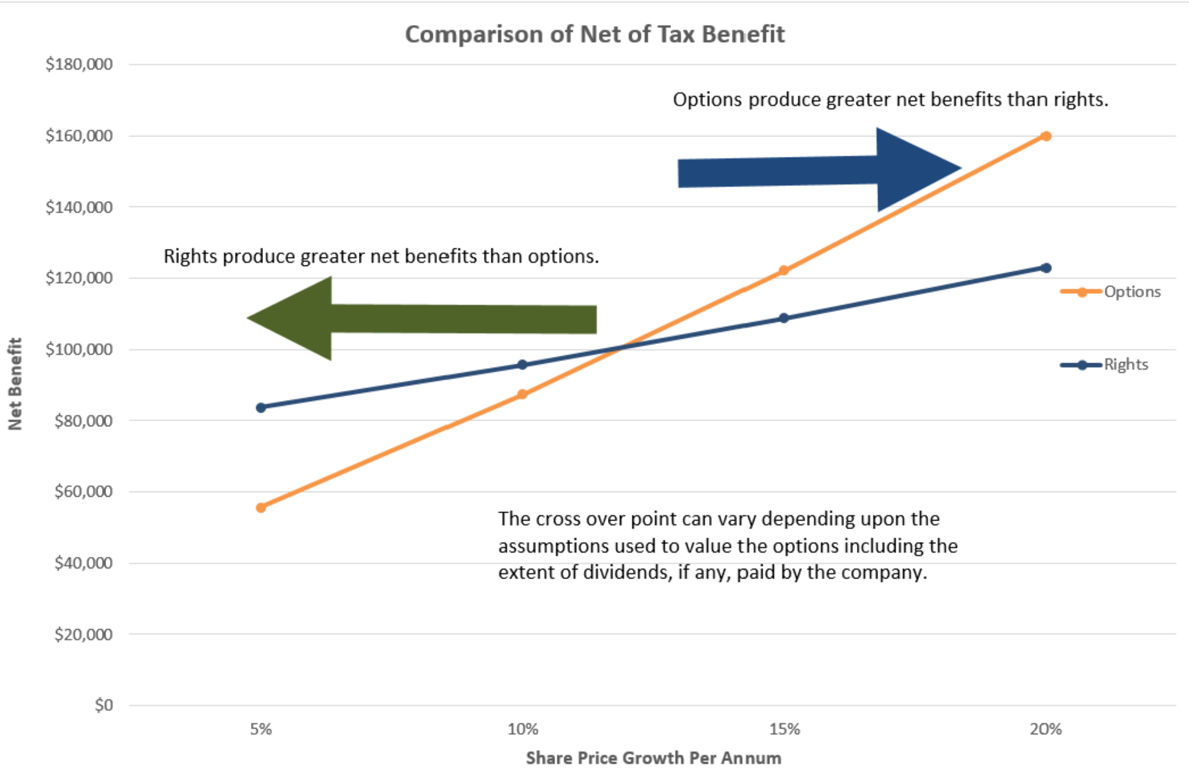
There are two important differences between the ways that that most options on the one hand and rights and shares on the other hand are designed. These important differences are that:

a) Options have an exercise price that the share price needs to exceed before any benefit arises for option holders whereas rights do not, and

b) For a given value of LTI, more options need to be granted than rights or shares, as rights and shares have higher values than options.

These two features produce relative net benefits for participants broadly as indicated in the following table (trend lines are important not the absolute numbers which are illustrative only). Where the cross over occurs will depend upon the assumptions used in the analysis. However, it is clear that:

- at lower levels of compound annual growth rate (CAGR) in the share price over a 3 year period, rights produce greater net benefit, and
- at higher levels of CAGR in the share price over a 3 year period, options produce greater net benefit.



Ignoring other aspects it is clear that options will generally be the more appropriate type of security to use for LTI purposes when companies have high risk operations and are pursuing exceptional growth in their share price. However, it is often the case that high risk companies are startup companies with small market capitalisations. For such companies options are often not appropriate as they would lead to excessive dilution if grants of options were to be set at levels needed to deliver market competitive incentives for executives, let alone other employees.

Other problems with using options have been that:

a) tax is payable on the grant value if vesting conditions are not attached, and

b) it is possible for most vesting conditions except absolute challenging share price growth, to result in a taxable value at vesting even though there is no accrued benefit (excess of share price over exercise price) in the option.

These problems have contributed to a substantial decrease in the use of options.

When options are not appropriate rights may need to be used. In GRG's experience it is more common for rights to be seen as preferable to options.

SPLP Replicating Rights Or Options

A basic SPLP is similar to an option plan except that if dividends are paid by the company, the net of tax dividends are applied to reduce the loan balance. The reduction of the loan balance with net dividends is equivalent to an option with a reducing exercise price. The reduction may be offset by setting the purchase price of the shares at a premium equal to the expected loan reduction over the vesting period.

An SPLP may also be structured to replicate a rights plan by introducing a loan waiver such that the participants receive the same net of tax benefit from the initial value of a share as they would from a right. The loan waiver would be applied when shares vest and would equal the net of tax benefit the participant would receive from the grant value of a right. Loan waivers are tax free for participants as they are subject to fringe benefits tax (FBT) which is payable by the company. The cash outflow due to the FBT payment makes this variation less attractive to most companies than a rights plan.

Choosing SPLP Over Rights Or Options

Given that SPLPs may be designed to replicate options and rights plans it would appear that SPLPs would be preferable due to share price growth being taxed as a capital gain (50% tax free after 12 months holding) rather than as an ESS benefit (100% taxable).

However, consideration also needs to be given to the cost to the company of the various plans. Each of the plans involves various company costs as follows:

Plan Types and Elements		Profit and Loss (P&L) Expense	Tax Deductibility
Option Plan	Value of options at grant	Amortised over vesting period	No deduction
	Contributions to employee share trust (EST) in respect of the accrued benefit in vested options	Not a P&L expense	Fully tax deductible and may exceed the value of options expensed
Rights Plan	Value of rights at grant	Amortised over vesting period	No deduction

Plan Types and Elements		**Profit and Loss (P&L) Expense**	**Tax Deductibility**
	Contributions to EST for market value of shares to be provided in respect of vested rights	Not a P&L expense	Fully tax deductible and may exceed the value of rights expensed
SPLP Replicating Options	Value of grant calculated as if options granted	Amortised over vesting period	No deduction
SPLP Replicating Rights	Value of grant calculated as if options granted	Amortised over vesting period	No deduction
	Loan waiver	Expensed in year incurred	Deductible
	FBT	Expensed in year incurred	Deductible

From the foregoing table it is clear that SPLP grants involve additional cost to the company due to the absence of tax deductible contribution to an EST.

A fundamental principle of remuneration planning is that all elements of remuneration should be brought onto a common footing being the equivalent of a tax deductible expense. For SPLP grants to be placed on this footing the value of the grant calculated as an option needs to be grossed-up (÷ (1 – Company tax rate)) to account for the lack of a tax deduction. When this adjustment is made to the value of grants under SPLPs, the number of shares to be offered reduces and so does the net benefit for participants from a given level of remuneration cost.

When properly costed the tax advantages of SPLPs for participants tends to be offset by the tax disadvantages for the company. Accordingly, considerations other than taxation will need to be taken into account when choosing between SPLPs and other LTI plans.

Other areas of difference between SPLPs and other plans include

a) SPLPs tend to be more dilutive than options when the plan replicates options since cashless exercise of options cannot be replicated under an SPLP,

b) SPLPs tend to involve more administration than option and rights plans, and

c) SPLPs tend to be out of favour with proxy advisors and other stakeholders and therefore involve a stronger commitment to communication with these stakeholders so as to gain their acceptance and support for the plan.

For these reasons SPLPs remain uncommon.

Details of incentive plan practices for key management personnel (KMP) including detailed comparisons of the main types of LTI plans is contained in the 2014 GRG KMP Incentives Guide. Copies of this Guide are available on a complimentary basis and may be requested via info@godfreyremuneration.com.

Conclusion

The selection of the most appropriate LTI plan for KMP is a complex decision which needs to be periodically reviewed as do the plan rules and the terms of individual offers. While one plan type will not necessarily be the most appropriate for all companies in their various specific circumstances it seems clear that for most companies a rights plan will be the preferred plan type.