GRG Remuneration Insight 80

10% Shareholding Barrier to LTI Participation Overcome

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Introduction

A long standing problem for executives who own or control more than 10% of issued shares in a company, is that the employee share scheme (ESS) taxing provisions exclude them from tax deferral in relation to long term incentive (LTI) grants of share rights to executives. This problem has led to such executives either not participating in LTI plans or having a separate LTI plan which isolated them from other executives.

The same taxation consequences also applied to equity grants to non-executive directors as part of their remuneration. However, the implications for executives have been more serious for executives than directors. This has been because LTI grants to executives are a critical part of their remuneration whereas equity grants to NEDs have been seen as a desirable but not essential element of NED remuneration.

This GRG Remuneration Insight canvasses the problem of no tax deferral and introduces an approach that can allow executives with large shareholdings in the company to participate in an LTI plan on the same basis as other executives and yet not be liable for tax on the value of unvested LTI at the date of the grant.

Illustration: Assumptions and Variables

To illustrate the different positions that can arise it is assumed that each executive receives an LTI grant with a 3 year measurement period for vesting. It is also assumed that 60% of the LTI grant vests and that the remainder of the rights lapse.

The main variables that change with the illustrations are:

- The level of shareholdings of the executives, and
- The nature of the rights granted to the executives.

Base Case: The Majority of Executives (No More Than 10% Shareholding)

If an executive with less than a 10% shareholding is granted share rights subject to vesting conditions (performance and/or service) and they remain employed long-term then:

- No tax is payable in relation to the grant,
- Tax only arises on the latter of:
  - The date of vesting, and
  - The date any disposal restrictions cease to apply to the rights and shares acquired on exercise of the rights.

The tax payable is referred to as employee share scheme (ESS) tax as the taxing point is governed by the ESS taxing provisions of the Income Tax Assessment Act.

The following table illustrates the position of such an executive given the simple assumptions indicated in the table:

Illustration of a Typical Executive				
Aspect	**Number**	**Share Price**	**Value**	**Comments**
Grant of Unvested Share Rights	100,000	$2.00	$200,000	
ESS Tax On Grant			$0	
Value After 4 Years of Rights that Vested	60,000	$4.00	$240,000	Assumed that vested share rights are exercised and immediately sold
ESS Tax On Exercise & Sale			$112,800	Tax at the executive's marginal tax tate (assumed to be 47%) payable on 100% of the value at exercise
Net Benefit			**$127,200**	

An important consideration for most executives is that shares acquired by exercising the rights may be sold to cover the tax liability, at the time the tax liability falls due.

Outcome for Executives With More Than 10% Shareholding & Granted Share Rights

If an executive holds more than 10% of issued shares is granted share rights then:

- ESS tax is payable on the value of all the unvested share rights at the date of grant,
- The executive will need to fund the cost of funds used to pay the tax from personal savings or debt or selling other investments,
- On vesting and lapse of rights that do not vest a refund of the tax paid in respect of the lapsed share rights may be obtained (only applied from 1 July 2015), and
- On sale of the shares acquired by exercising the rights, capital gains tax (CGT) will apply to the gain and the 50% CGT concession will apply provided that the shares have been held for 12 months prior to sale (to incorporate this feature the time period was set at 4 years being composed of a 3 year vesting period and a one year holding period for shares after exercise of the rights).

The following table illustrates the position of such an executive given the simple assumptions indicated in the table:

Illustration of an Executive With >10% Shareholding and Share Rights				
Aspect	**Number**	**Share Price**	**Value**	**Comments**
Grant of Unvested Share Rights	100,000	$2.00	$200,000	
ESS Tax On Grant			$94,000	Tax at the executive's marginal tax tate (assumed to be 47%) payable on 100% of the value at grant
Value After 4 Years of Rights that Vested	60,000	$4.00	$240,000	Assumed that vested Rights are exercised and sold a year later
Less portion of ESS tax applcable to rights that vested			$56,400	The excess ESS tax paid at grant is refunded
CGT			$28,200	CGT applies to value growth between grant and sale
Cost of funding tax between grant and sale of shares			$44,831.2	It is assumed that interest at 12% is paid on funds borrowed to pay the tax on unvested rights at grant ($94,00 for 3 years and $56,400 for one year)
Net Benefit			**$110,569**	

In the illustration an interest rate of 12% is used in relation to the funds used to pay the upfront tax. The 12% was chosen as it represents the long term return generated on investment in shares listed on stock exchanges. Thus it in effect assumes that monies that would otherwise have been invested in the stock market have been applied to fund the tax payment. This assumption ignores CGT that may be payable if shares need to be sold to fund the tax. It also ignores that higher (or lower) returns may have been generated had the funds been left in the stock market.

As expected the executive who pays tax upfront realises a lower benefit than executives who have the advantage of tax deferral.

Preferable Position For Executives With More Than 10% Shareholding

If an executive who will hold more than 10% of issued shares is granted rights that may be settled in cash or shares (but which are satisfied as shares after four years) then:

- On sale of the shares acquired by exercising the rights CGT will apply to the gain and the 50% CGT concession will apply provided that the shares have been held for 12 months prior to sale,
- ESS tax will be levied on the value at grant of rights that vest and a minimal charge will apply to the delayed payment of tax.

The following table illustrates the position of such an executive given the simple assumptions indicated in the table:

Illustration of an Executive With >10% Shareholding and Rights				
Aspect	**Number**	**Share Price**	**Value**	**Comments**
Grant of Unvested Rights	100,000	$2.00	$200,000	
ESS Tax On Grant			$0	
Value After 4 Years of Rights that Vested	60,000	$4.00	$240,000	Assumed that vested Rights are exercised and immediately sold
Less portion of ESS tax applcable to rights that vested			$56,400	
CGT			$28,200	CGT applies to value growth between grant and sale
Interest charge on ESS tax between grant and sale of shares - 4 years at 5.5% interest			$13,470	The charge applicable to the delayed tax payment is 5.5% p.a.
Net Benefit			**$141,930**	

These outcomes can be achieved with a properly designed LTI plan that qualifies for product disclosure etc. relief under Class Order 14/1000.

Summary

The following table summarises the key features of the illustrations.

Aspect	Typical Executive	Executive With >10% Shareholding and Share Rights	Executive With >10% Shareholding and Redesigned Rights
Net Benefit	$127,200	$110,569	$141,930
Upfront Tax	No	Yes	No
CGT on Growth	No	Yes	Yes
Cost Related to Tax Deferral	No	Yes	Yes

The above table clearly shows that there is no reason for an executive with a major shareholder not to participate in an LTI plan, if it has been designed and implemented to facilitate this outcome. Accordingly, there is no reason for all executives not to participate in the same LTI plan, which is generally seen as good governance and supporting shared goals that are in the interests of all shareholders.