GRG Remuneration Insight 81

No Risk Salary Sacrifice Share Investments

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Introduction

Pre-tax investment in company shares has long been an attractive employee benefit, and it is now even more attractive due to an innovative new approach that;

- removes limits on the amounts that may be salary sacrificed,
- provides a guarantee of no loss even if the share price falls, and
- results in lower overall tax being paid.

What are Salary Sacrifice Share Investments?

Salary sacrifice share investments arise when part or all of:

a) annual salary,

b) short term incentive (STI) awards, or

c) fees for non-executive directors,

are sacrificed/foregone and the amount sacrificed/foregone is replaced with an investment for the benefit of the employee in company's shares under a company sponsored plan.

Innovation in Salary Sacrifice Share Investments

GRG has undertaken extensive analysis which led to recognition of long term tax deferred saving opportunities based on investment in company shares. The key aspects of the new optimised approach include:

1. Access to the benefits of tax deferral i.e. more net benefit from share price growth and more dividends,
2. No need to satisfy the 75% test, making it easier for employers to introduce salary sacrifice for selected categories of employees,
3. No $5,000 annual limit, thereby allowing employees to select the level of savings that suits their needs,
4. No fixed disposal restriction period thereby allowing employees to select when they wish to be taxed which in many cases will be when they wish to sell shares,
5. No risk of loss from a fall in the share price, and
6. More tax effective due to lower tax on share price growth.

In addition the company will experience cash flow advantages which can lead to improved profitability. Thus, salary sacrifice is an attractive employee benefit that will also benefit the company and its shareholders.

Taxation Advantage of Pre-tax Investments

The following table compares the net of tax benefit from investing the same gross amount in company shares but under two different methods; after tax investments such as may be made by any investor, vs the current standard approach to salary sacrifice arrangements. Clearly the standard salary sacrifice approach produces more benefits than after tax investments, and the benefits arise from two aspects being:

- lower overall tax on the investment in shares, and
- more dividends as more shares are held under the salary sacrifice approach.

Aspect	Rate	After Tax Investment	Standard Salary Sacrifice
Gross Amount		$5,000	$5,000
Less Income Tax	47%	$2,350	$0
Net Investment in Shares		$2,650	$5,000
Value of Shares After 8 years at CAGR of	8%	$4,905	$9,255
Capital Gains Tax on 50% of gain	47%	$530	$0
ESS Tax & Charges	47%	$0	$4,350
Net Value of Shares		**$4,375**	**$4,905**
Dividends accumulated over the period at	4%	$848	$1,600
Net Benefit		**$5,223**	**$6,505**
		% gain from using salary sacrifice	**25%**

The simple assumptions used in the foregoing illustration are:

a) the example is based on the maximum annual amount of salary sacrifice into shares of $5,000 which applies to current standard approaches, so additional share investments would need to be made as after tax investments (note: this example has not modelled the impact of the optimised approach, which appears later in this document),

b) personal marginal tax rate including Medicare Levy of 47%,

c) The shares are held for 8 years,

d) The share price increases at 8% compound annual growth rate,

e) The shares acquired as an after tax investment qualify for the 50% CGT concession i.e. 50% of the growth in value is tax free,

f) The salary sacrifice shares qualify for tax deferral for 8 years and the shares are immediately sold when the taxing point arises,

g) Dividends are calculated as 4% each year of the original cost of the shares net of tax after imputation credits are taken into account,

h) Under both alternatives the risks of investing in company shares are equal as other forms of investment are not considered.

Alignment Advantages

In addition to the financial benefits, salary sacrifice share investments also convert employees into shareholders. Thus their perspective as stakeholders in the company will change from the sometimes myopic view of an employee to the binocular view of a person who is both an employee and a shareholder.

This change of perspective should improve employee/employer relations, create more interest in the success of the company and open communication channels. Most stakeholders could therefore be expected to support such programs.

Current ESS Constraints

Under the employee share scheme (ESS) taxing provisions, tax deferral is only available for salary sacrifice into shares if three main conditions are satisfied:

a) when the shares are acquired at least 75% of permanent Australian resident employees of the employer who have completed three or more years of service (whether continuous or non-continuous) have been entitled to acquire ESS interests (shares, rights options etc.) under the scheme or another employee share scheme of the employer or its holding company – the 75% test,

b) the total value of the shares acquired during the year must not exceed $5,000, and

c) disposal restrictions must be attached to the shares and included in the offer of shares (real risk of forfeiture could be used to defer the taxing point but would not be a practical choice for salary sacrifice as employees would not risk possible loss of the investment just to defer tax).

These three constraints represent significant impediments to companies introducing and employees participating in salary sacrifice share investments.

Many companies prefer to offer salary sacrifice share investment to selected categories of employees e.g. those not subject to an industrial agreement and do not wish to offer it to all employees. If the target employee group represents less than 75% of permanent Australian resident employees with three or more years of service then salary sacrifice will only be an available alternative if a general employee share scheme is in operation satisfying the 75% test. Of course, the 75% test is applied on an employer by employer basis. Thus, if a conglomerate has several employer companies as part of the group then each employer company needs to satisfy the 75% test for its employees to qualify for tax deferral in relation to offers of shares. Whether 75% of permanent Australian resident employees have three or more years of service may vary on a daily basis as continued service will mean that additional employees will meet the test, new hires will push the percentage down and terminations may influence the percentage up or down depending on the mix of service of those that cease to be employees.

While $5,000 is not an insignificant amount of money, it will not meet the preferences of many employees who may wish to invest greater amounts into company shares. This restriction will undoubtedly result in a lower amount overall being invested in shares via salary sacrifice.

Disposal restriction periods are also problematic in that:

- if the employer prescribes a fixed period for all salary sacrifice share acquisitions then the period is unlikely to be optimal for most employees and will make the investment less attractive due to its inflexibility as to the timing of the taxing point which tends to trigger a need to sell shares,
- If the employer allows the employees to select their personal disposal restriction periods up front (cannot be decided later) then this adds to administration and adds a complication for employees of having to determine in advance when they may wish to sell shares,
- If broad disposal restrictions are applied with an opportunity for their early release then there can be delay in obtaining the release and, in any event, the effectiveness of such disposal restrictions may be open to challenge by the Australian Taxation Office as being a “Claytons” disposal restriction (i.e. one which is not real) resulting in up-front taxation and loss of the tax deferral benefit.

The last of the main impediments to achieving maximum participation in salary sacrifice arrangement is the risk aversion of many employees who, perhaps, are not experienced with investing on the stock market or who would otherwise diversify their investment to reduce risk (noting that the removal of risk of loss from a fall in the share price should negate the need for such diversification when the optimised salary sacrifice share plan is used).

Necessary Supplement to Superannuation Savings

While superannuation is meant to be the main form of saving for retirement it does not fully achieve this objective for many employees. For medium to higher income earners the superannuation guarantee contribution (SGC) rate is well below the rate needed to build an adequate retirement nest egg. The maximum required SGC amount for FY17 is $19,616 on salary of $206,480. Additional salary is not subject to SGC. The gap between the SGC required rate and the concessional contributions limit ($30,000 for those under age 50 and $35,000 for older persons) allows limited scope (approx. $10,000 to $15,000 depending upon age) to fill the retirement saving gap but is not attractive for many employees who prefer to have the option of being able to access the savings before retirement should circumstances warrant such access.

With the extended tax deferral period available under innovative new programs, optimised salary sacrifice represents a viable supplement to superannuation as a long term savings mechanism with low risk and optimal benefits.

Additional Tax Benefit

As well as overcoming the taxation impediments discussed earlier and providing a no-risk guarantee, the optimised salary sacrifice share plan involves lower tax than the standard salary sacrifice approach as illustrated in the following example:

Aspect	Rate	After Tax Investment	Optimised Salary Sacrifice
Gross Amount		$10,000	$10,000
Less Income Tax	47%	$4,700	$0
Net Investment in Shares		$5,300	$10,000
Value of Shares After 8 years at CAGR of	8%	$9,810	$18,509
Capital Gains Tax on 50% of gain	47%	$1,060	$2,000
ESS Tax & Charges	47%	$0	$6,768
Net Value of Shares		**$8,750**	**$11,741**
Dividends accumulated over the period at	4%	$1,696	$3,200
Net Benefit		**$10,446**	**$14,941**
		% gain from using salary sacrifice	**43%**

Implementation

To implement salary sacrifice share investment requires:

- establishment of a plan through which salary sacrifice is effected,
- engagement with employees to explain the opportunity and to allow them to join the plan,
- distribution of dividends, and
- regular communication as to their shareholdings.

Those companies with old style salary sacrifice arrangements should consider phasing them out and replacing them with the new optimised style.

Those companies that currently do not have a salary sacrifice plan should obtain advice on the detailed design of such a plan so that a decision may be made in relation to implementation.

It should be noted that knowledge of the optimised approach to salary sacrifice share acquisitions is restricted so many tax, legal and remuneration advisors etc. may not yet understand the approach. GRG can provide assistance should you have any questions.