GRG Remuneration Insight 94

Making Employee Equity Plans More Attractive

Nida Khoury & James Bourchier | February 2017

Introduction

Compounding is the foundation of wealth accumulation. Albert Einstein made the comment that "**compound interest** is the eighth wonder of the World. He who understands it …. earns it, …. he who doesn't, pays it". Warren Buffett, arguably the world's most successful investor, has reportedly singled out **compound interest** as the most powerful factor behind his investing success.

Other than superannuation, which has many limitations, there is only one employee benefit which companies can offer their employees to help put them on the road to financial security. That benefit is a General Employee Equity Plan (GEEP).

When properly structured, GEEPs can provide employees with the powerful benefits of compounding.

What is a GEEP

A GEEP is a plan that enables company employees to acquire shares or interests in shares in their employer. The funding of the acquisition of equity may be from employees, the employer or a combination of both.

GEEPs Benefit the Company

It is generally accepted that GEEPs have the following benefits for the company:

1. employees as shareholders have a vested interest in the company's profitability and future prosperity,
2. employee engagement and productivity are improved,
3. employee/employer relations are improved,
4. employees share in the success to which they contribute,
5. the GEEP can become a distinguishing remuneration arrangement that contributes to making the company an employer of choice, and
6. growing companies will realise GEEP tax savings that are higher than those available from standard salary payments. Assuming dividends represent 50% or less of a Company's return on capital, the Company is also likely to benefit significantly from the investment of funds that would otherwise have been unavailable.

These benefits alone should be sufficient to outweigh the costs of developing, introducing and administering a GEEP plan.

Compounding and GEEPs

The three main aspects that contribute to compounding available under GEEPs are:

1. **Maximise investment savings** — Employee savings for investment via a GEEP should be made on a pre-tax /salary sacrifice basis because more shares can be acquired from before rather than after tax investments. For example, if the share price is $10, an employee on a 40% marginal tax rate who allocates $10,000 of pre-tax income to a GEEP will acquire 1,000 shares whereas $6,000 will be available after-tax and only 600 shares can be acquired. If the Company is dividend paying, the participant will receive 67% more dividends compared to after tax investment.

2. **Reinvest dividends** — A key aspect that enhances the power of compounding is increasing the size of the investment pool. This can be achieved by reinvesting dividends, which also leads to more dividends from larger future holdings of shares. For example, if 1,000 shares with a market value of $10,000 are held and a 5% dividend is declared then $500 will be received and used to invest in another 50 shares.

   Tax payable on dividends has been ignored in this example. Under basic approaches tax needs to be paid when dividends are received which reduces the amount available to be invested in shares. However, under well designed GEEPs tax on dividends is deferred thereby allowing more to be reinvested into shares.

3. **Delay taxing point and selling shares for as long as possible.** — The taxing point for shares acquired under a GEEP at best coincides with the time when shares are sold and part of the value of the investment will be lost to pay the Taxation Office, which reduces the invested value. Accordingly, the taxing point and sale of shares should be delayed as long as possible to maximise the invested value and allow the benefits of compounding to work its magic.

In regard to the foregoing it should be noted that tax related benefits directly correlate with the marginal tax rates being paid by employees. Thus, tax benefits will be greatest for higher income earners and least for lower income earners.

Simple Illustration

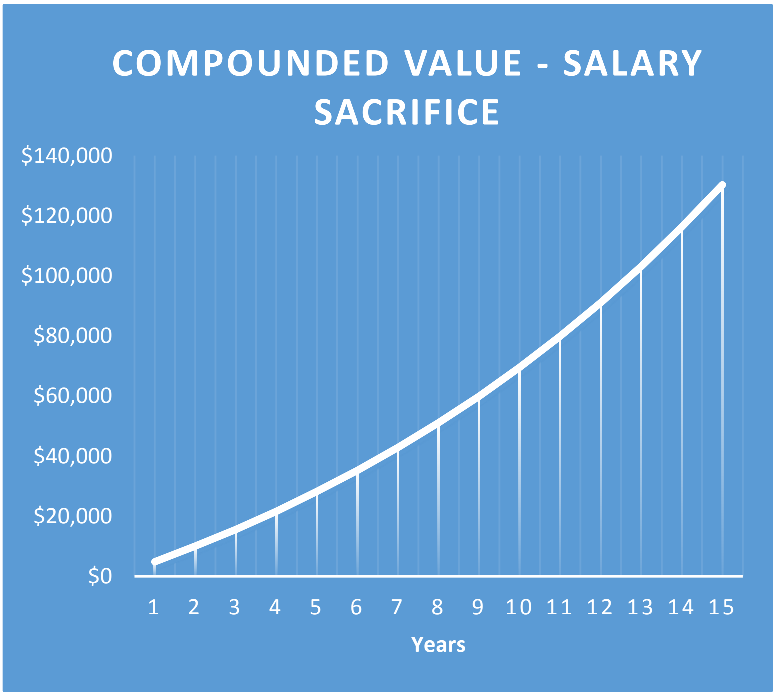
The following graph presents a simple illustration of the power of compounding.

This example is based on the following assumptions:

- $400 is salary sacrificed and invested each month,
- the share price grows at 4% p.a. and the dividend yield is 4%,
- earnings are added to the investment, and
- tax is deferred.

Total savings amount to $72,000, yet the compounded value grows to over $130,000.

Note: Tax will need to be paid on the salary sacrifice compounded value but the tax will be a lesser proportion than it would have been had the employee tried to save after tax earnings, even taking into account CGT treatment when applicable.



Maximising Employee Participation in GEEPs

There are many advantages that may be offered to employees to encourage participation in GEEPs and these are discussed below.

A. Progressive Savings for Investment and Reduced Acquisition Costs

Generally, there is a two step process for employees to invest their after-tax income into company shares:

1. Saving after-tax income until a sufficient amount accumulates to fund the purchase of a reasonable number of shares (this means that shares will be acquired at the market value prevailing at the time of the purchase which may be higher or lower than the average price that prevailed over the savings period), and
2. Acquiring shares via periodic on-market purchasing which involves the employee in funding the acquisition costs (brokerage) multiple times.

Under a salary sacrifice GEEP there would be monthly acquisitions of shares thereby averaging the cost price over the savings period and there would be no acquisition/brokerage costs, if the company issues shares. These benefits can be provided at no direct additional cost to the company.

B. Pre-tax Funding

Many GEEPs allow funding of share acquisitions to be from pre-tax remuneration. This represents a distinct advantage not available to employees when they fund share acquisitions from after-tax income. This benefit can be provided at no additional cost to the company.

C. Guarantee

A recent innovation in relation to GEEPs is including a capital guarantee, which means that employees will not receive less than the amount of their salary sacrifice investment even if the share price falls. The purpose of the guarantee is to remove impediments to participation that may otherwise have led to many not engaging in salary sacrifice acquisitions because of risk aversion. Such guarantees do not cover loss of gains made subsequent to the acquisition of the shares i.e. they may lose gains made after acquisition of the shares but not their initial investment.

A guarantee of this type represents a major advantage for employees and can be provided at no additional cost to the company.

D. Discounts/Matching

A method that has been used for many years to encourage employee participation in GEEPs has been to offer shares at a discount to their market value. Such discounts have usually been put into effect as matching contributions (e.g. for each four shares funded by the employee the company funds one additional share, in effect resulting in a 20% discount). Of course, the shares acquired by matching contributions may be subject to minimum holding or service periods in order to obtain additional benefits for the employer in return for the additional cost. Such approaches may be targeted to parts of the business where turnover or succession are of key interest. This benefit involves additional cost to the company but can be set at levels deemed acceptable.

Conclusion

Each company needs to determine the extent to which it should go to encourage employee participation in GEEPs. At senior employee levels it is likely that price cost averaging, nil acquisition costs and taxation advantages will suffice to encourage participation. At lower employee levels where disposable income is scarce for investment it is likely that stronger inducements will be required to achieve significant levels of employee GEEP participation. For this group it is possible that a guarantee and/or matching contributions will be required.

These factors may lead to considering the possibility of having different plans for different employee levels, however, it would generally be expected that the basic terms of a single GEEP would apply equally to all levels of potential participants.