GRG Remuneration Insight 133

The Myth of CGT Tax Advantages

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INTRODUCTION

In undertaking our work with a broad range of equity plans, we often encounter participants, even directors, executives and finance professionals, who mistakenly believe that capital gains tax (CGT) tax treatment produces a better outcome than the tax deferral available under the Employee Share Scheme (ESS) tax provisions of the Income Tax Assessment Act (Tax Act). This perception arises because the absolute value of tax paid under an ESS arrangement is generally substantially higher, however, people neglect to recognise that the net benefit is also higher, **with ESS tax producing an outcome equivalent to an effective CGT rate of nil/0%**. This Insight demonstrates this with worked examples, and discusses key myths and misconceptions we often encounter.

CHAPTER 1 - ESS ALWAYS SLAYS THE CGT BEAST

A Simple Example

The following assumptions are used for a first, simple example based on Rights subject to deferred "ESS Tax", as they are the most frequently used instrument in employee equity schemes:

General Assumptions	Value
Price at Grant	$1.00
Years Held (period before first exercise date)	3
Share Price Compound Annual Growth Rate	**10.0%**

The following simplified example shows the outcome of up-front tax and CGT treatment from day 1, compared to ESS tax deferral, ignoring discounts and dividends, to isolate the tax difference first:

Aspect	Variables	Share Purchase or Grant of Rights With Up Front Tax	Rights With Deferred Taxing
Gross Amount		$100,000	$100,000
Example Personal Tax Rate	47%	$47,000	$0
Investment in Company Shares		**$53,000**	**$100,000**
Value of Instrument at Grant		$1.00	$1.00
Shares or Rights Acquired		53,000	100,000
Share Price at End/Sale	$1.33	$70,543	$133,100
Gross Benefit from Rights		$70,543	$133,100
CGT		$4,123	$0
ESS Tax		$0	$62,557
Net Share Price Growth Benefit		$66,420	**$70,543**
Difference Due to Tax Treatment Only		**-6%**	**$4,123**

In this example, a 6% net advantage is received due to tax deferral alone, despite more than $10,000 in additional tax being paid under the ESS approach. The advantage of ESS treatment is $4,123, which is in fact exactly the amount of CGT paid (on a 50% of the capital gain being tax free basis) in the CGT scenario i.e. **the impact of ESS taxation over CGT taxation is tantamount to a CGT tax rate of nil/0%, and this will always be true where ESS is available over a CGT alternative, regardless of what variables or growth rates you input.** This is because we have assumed the Participant sells sufficient Rights/Shares up front to pay the up-front tax bill, and the growth in share value under the ESS approach applies to a larger number of share interests, when tax is deferred under the ESS approach.

CHAPTER 2 – THE RED "*I Can Fund the Tax Bill Up Front from Another Source*" HERRING

Those unfamiliar with this debate may argue that they can fund the up-front taxation under the CGT scenario, from another source, such as from personal savings, selling other shares, or obtaining a nil interest loan. This would allow them to hold the same number of interests as applies under the ESS scenario (effectively buying-back the shares that would otherwise be sold to pay the tax). In order to ensure that the comparison remains like-for-like, we then also need to assume the ESS taxable participant invests that same amount of additional funds at the same time, as shown below:

Aspect	Variables	Share Purchase or Grant of Rights With Up Front Tax	Additional Employee Cost With Tax Paid	Combined	Rights With Deferred Taxing	Additional Employee Investment Equivalent to Tax	Combined
Gross Amount		$100,000			$100,000		
Example Personal Tax Rate	47%	$47,000			$0		
Investment in Company Shares		**$53,000**	**$47,000**	**$100,000**	**$100,000**	**$47,000**	**$147,000**
Value of Instrument at Grant		$1.00	$1.00		$1.00	$1.00	
Shares or Rights Acquired		53,000	47,000	100,000	100,000	47,000	147,000
Share Price at End/Sale	$1.33	$70,543	$62,557	$133,100	$133,100	$62,557	$195,657
Gross Benefit from Rights		$70,543	$62,557		$133,100	$62,557	
CGT		$4,123	$3,656		$0	$3,656	
ESS Tax		$0	$0		$62,557	$0	
Net Share Price Growth Benefit		$66,420	$58,901	**$125,322**	**$70,543**	$58,901	**$129,444**
Difference Due to Tax Treatment Only				**-3%**			**$4,123**

In this example the ESS tax treatment produces a net benefit that is still around 3% better than the CGT scenario, assuming the Participant invests the same amount as they would have spent paying the tax bill up-front, in Company Shares up-front. The benefit still equals the CGT paid on the primary amount.

CHAPTER 3 – DIVIDEND; THE UNSUNG HERO OF ESS

The presence of dividends actually improves the ESS outcome relative to up-front tax and CGT treatment, as demonstrated below, based on the following, additional assumptions:

General Assumptions	Value
Price at Grant	$1.00
Years Held	3
Share Price Compound Annual Growth Rate	**10%**
Dividends p.a.	$0.050
Franking %	100.0%
Franking Credit	$0.0214
Tax Payable on Dividends	$0.0121
Net of Tax Dividend	$0.038
Company Tax Rate	30%

Aspect	Variables	Share Purchase or Grant of Rights With Up Front Tax	Rights With Deferred Taxing
Gross Amount		$100,000	$100,000
Example Personal Tax Rate	47%	$47,000	$0
Investment in Company Shares		**$53,000**	**$100,000**
Value of Instrument at Grant		$1.00	$0.85
Shares or Rights Acquired		53,000	117,647
Share Price at End/Sale	$1.33	$70,543	$156,588
Gross Benefit from Rights		$70,543	$156,588
CGT		$4,123	$0
ESS Tax		$0	$73,596
Net Share Price Growth Benefit		$66,420	**$82,992**
Net of Tax Dividends		**$6,019**	**$0**
Total Net Benefit		**$72,440**	**$82,992**
Difference Due to Tax Treatment Only		**-15%**	**$10,552**

Because of the presence of dividends, the benefit of ESS treatment rises to around 15% based on the same assumptions as the previous examples (using a typical 5% yield). This is because the grant value of Rights (grey cell) is discounted for the loss of dividends at grant (please refer to Black-Scholes models for the basis of this fact, i.e. ignoring any vesting conditions). If the Rights are not discounted for the loss of dividends, they would need to be entitled to dividend equivalents in order for them to be equivalent in the example (which is a feature of some Rights plans where dividend discounts do not apply to granting calculations). If dividend equivalents applied, then even without a discounted allocation price, twice as many share interests are held because they did not have to pay tax up front, thus doubling the dividends.

CHAPTER 4 – MYTHICAL CGT ADVANTAGES CAST A CURSE ON COMPANY PROFITS TOO

There are still companies out there that use share purchase loan schemes (SPLPs) with the main reason given being this CGT benefit myth. This only holds up when the Company absorbs the cost of the CGT disadvantage, and to show this we need to add some assumptions outlined below. To give the myth a fighting chance lets also assume the loan to buy shares is non-recourse, and not subject to any interest (many SPLP loans are subject to an interest rate or interest equivalent to the dividend rate, which would further reduce the net benefit).

Options/SARs/SPLP Assumptions	Value
Share Price or Loan $	$1.00
Exercise Price or Loan Repayment	$1.00
B-S Valuation Risk Free Rate	1.0%
Volatility	50%

Unfortunately the CGT myth starts the battle wounded, because the Company necessarily foregoes a tax deduction when an SPLP is used, which adds to the cost to the Company, as shown below. If this additional cost is ignored, it may appear that an SPLP performs slightly better under these assumptions. Unfortunately the additional cost to the company is more than the additional benefit to the participant, making this approach particularly inefficient. Once the additional company cost is taken into account in determining the grant number, which needs to be done to ensure the comparison is in fact like-for-like, Rights subject to ESS taxation, and indeed Share Appreciation Rights (SARS which are a modern, superior alternative to old Option or SPLP structures where the Exercise Price is "notional") outperform the SPLP (it should also be noted that the SPLP is exceptionally dilutive if new issues are used):

Aspect	Variables	After Tax Investment	Rights	SARs	SPLP (ignoring additional company cost)	SPLP (company cost adjusted grant)
Gross Amount		$100,000	$100,000	$100,000	$100,000	$100,000
Example Personal Tax Rate	47%	$47,000	$0	$0	$0	$0
Investment in Company Shares		**$53,000**	**$100,000**	**$100,000**	**$100,000**	**$100,000**
Value of Instrument at Grant		$1.00	$0.85	$0.24	$0.34	$0.48
Shares or Rights Acquired		53,000	117,647	416,667	294,118	208,333
Share Price at End/Sale	$1.33	$70,543	$156,588	$554,583	$391,471	$277,292
Loan Repayment or Exercise Price		$0	$0	$416,667	$294,118	$208,333
Gross Benefit in Options/SARs/Shares		$70,543	$156,588	$137,917	$97,353	$68,958
CGT		$4,123	$0	$0	$22,878	$16,205
ESS Tax		$0	$73,596	$64,821	$0	$0
Net Share Price Growth Benefit		**$66,420**	**$82,992**	**$73,096**	**$74,475**	**$52,753**
Net of Tax Dividends		**$6,019**	**$0**	**$0**	**$33,403**	**$23,661**
Total Net Benefit		**$72,440**	**$82,992**	**$73,096**	**$107,878**	**$76,414**
Share Price Benefit Gain - Amount			**$10,552**	**$656**	**$35,439**	**$3,974**
Share Price Benefit Gain - %			**16%**	**1%**	**53%**	**6%**
Tax Deduction Saving for Company		**$30,000**	**$46,976**	**$41,375**	**$0**	**$0**
Net Company Cost		**$70,000**	**$53,024**	**$58,625**	**$100,000**	**$70,000**
Dilution/Shares Issued			**117,647**	**103,619**	**294,118**	**208,333**

CHAPTER 5 – THE MYTH IS NOT SAVED BY ITS COMPANION "*What-If?s*"

What if the Share Price falls? In that case you will certainly be worse off having paid tax up front on the higher Share price. What if you are a major shareholder or founder and hold 10% or more of the Company's Shares? In that case you can use Indeterminate Rights to defer the tax assessment until you exercise your Rights (CGT will be backdated to grant date if settled in equity), and these Rights may be settled in cash or equity depending on whether the share price has risen or fallen, giving you an optimal outcome in all cases. There is no "what-if" where the myth wins without unbalancing the comparison by ignoring a cost, tax deduction, or loss of gains, which must be absorbed by some party, somewhere.

CONCLUSION

While CGT tax treatment certainly offers benefits in the case of investment amounts on which tax or higher cost is paid by someone else, when it comes to employee equity, GCT benefits are a myth. When tax deferral is available, it will always produce a superior outcome when assessed on a truly like-for-like basis. Even for major shareholders/founders, we can use the ESS taxation structure to get better outcomes than up-front tax and CGT treatment. One must conclude that any companies with equity plans based on up-front taxation, or using Share Purchase Loan Plans, should really replace their schemes with ESS taxable schemes using Rights or SARs to save on cost, dilution, and improve benefits for participants.

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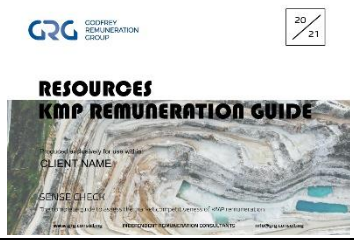

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