GRG Remuneration Insight 134

A Small Change Will Have a Major Impact

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INTRODUCTION

As part of the 2021 Australian Federal Budget, it was announced that for employee share scheme (ESS) taxing purposes, termination of employment will not be a taxing trigger point for grants made on or after 1 July 2021. This GRG Remuneration Insight discusses why this change will have a major impact on the design features of rights plans that are used for purposes of:

- Long term variable remuneration (LTVR),
- Deferral of short term variable remuneration (STVR), and
- Retention programs.

LEGISLATION NOT YET ENACTED

The legislation to give effect to the announced amendment to the ESS taxation laws had not been passed by Parliament at the time of writing this Insight. Accordingly, any changes being contemplated due to commentary in this Insight should be delayed until the amending legislation has received Royal Ascent and can be validated.

PRIOR PRACTICE

For some years, major ASX listed companies have been using indeterminate rights (under which the number of shares that will be provided when rights are exercised is unable to be determined until exercise, often achieved by a cash settlement choice being available to the Board) instead of share rights. At termination of employment the value of unvested indeterminate rights was not taxable whereas the value of unvested share rights was taxable. This was an important distinction, although the value of rights that subsequently were settled in shares became taxable on their value backdated to the date of termination of employment. This produced a messy situation, as prior year tax returns needed to be amended and a short fall interest charge may have been payable in relation to the amended tax liability. Nevertheless, this is a better situation than paying tax on unvested rights at termination, or bringing the rights to an early conclusion.

VESTING NEED NOT & SHOULD NOT BE TRIGGERED BY A TERMINATION OF EMPLOYMENT

Under LTVR plans it is usual for vesting of grants to be determined by reference to performance over a measurement period of 3 or more years. Further, the performance over the measurement period is often calculated by calculating the change between the beginning and end of the measurement period.

Under previous but now mostly superseded practice it was common for Boards to assess performance for the completed portion of the measurement period as of the date of the termination of employment. This practice was largely driven by the previously mentioned taxation of unvested share rights at termination of employment. Boards felt it was preferable to turn unvested rights into vested and lapsed rights rather than allow them to be retained as unvested rights. Also, some Boards preferred to sever connection with former employees after termination of employment. In many cases the default treatment was forfeiture of unvested Rights at termination (except in the case of death or disability – "Good Leavers") on the assumption that this produced an effective retention tool; an assumption that has been shown to be flawed due to the average tenure of participants in Australia being 4-5 years. The primary effect of this antiquated approach was to devalue the LTVR in the minds of participants and undermine true long-term alignment. Where Board discretion was exercised to allow the Rights to vest to the participant to override this default treatment, termination benefit limit problems typically arose, and the treatment was unfair to participants that remained employed and subject to outcomes at the usual time.

Better practice is now to allow unvested LTVR grants to be retained following termination of employment with a view to testing for vesting at the end of the measurement period. This ensures that:

a) Former employees are treated for vesting purposes the same as those employees who remain employed by the company.
b) Prior to termination of employment those employees who are ceasing employment with the company will be motivated to ensure that the company is left in the best possible position so as to maximise the chances of vesting of their LTVR grants at the end of their measurement periods. This may include succession planning and handover to a replacement.
c) Former employees will be discouraged from engaging in commentary or conduct in relation to the company or its competitors that may adversely affect the company's success.

Removal of termination of employment as a taxing point will facilitate retention of LTVR grants following termination of employment.

SKIN-IN-THE-GAME

A growing practice is for companies to have minimum equity holding policies for senior executives and directors and to apply disposal restrictions to shares acquired on exercise of rights (includes options) to ensure that tax is deferred on such shares to enable holding of shares to be maximised. Current best practice is for the equity holding requirements to continue for a period of at least 2 years following termination of employment. However, the old ESS taxing provisions triggered a taxing point at termination of employment irrespective of any disposal restrictions. Thus, it undermined continued holding policies.

Removal of termination of employment as a taxing point will facilitate retention of equity following termination of employment.

CLAWBACK AND MALUS POLICY SUPPORT THROUGH EXERCISE OR DISPOSAL RESTRICTIONS

Most companies are reluctant to pursue recovery of variable remuneration that has been paid in cash or settled in equity that has been exercised into shares. Yet recovery, when justified under a Clawback & Malus Policy, should be undertaken. Perhaps, the most efficient way to ensure that variable remuneration remains available for clawback recovery is for vested equity to be held in the form of vested rights. This may require the attachment of exercise restrictions to vested rights which will in turn need to be taken into account in valuing the rights (longer periods before rights may be exercised into shares with dividend entitlements reduce the value of the rights). The other approach to creating a pool for Malus and Clawback is to attach disposal restrictions on restricted shares but this is generally more problematic to recover and must be held in trust or subject to CHESS holding locks to defer tax.

The period of exercise restrictions or disposal restrictions should not be shortened by a termination of employment, but this often occurred in the past because of the old ESS taxing provisions. Removal of termination of employment as a taxing point will facilitate continuing exercise restrictions and disposal restrictions beyond termination of employment, typically for 2 to 3 years.

PLAN LIMIT

As indicated earlier in this Insight it is currently common practice to use indeterminate rights for LTVR purposes. Such rights are regarded as derivatives and not securities for Corporations Act purposes. This means that s708 of the Corporations Act cannot be relied upon for relief from disclosure (prospectus) provisions. Listed companies then relied upon ASIC Class Order 14/1000 for relief. This Class Order contains a limit of 5% of issued shares over a rolling 3-year period.

Many companies need to rely on Class Order relief when they are issuing equity instruments to employees who are not senior managers and can be constrained in the issue of equity instruments when issues to both senior managers and other employees rely on the Class Order for relief. This situation will be alleviated by the change to the ESS taxing provision as share rights may be used for senior managers in the future with reliance on s708 of the Corporations Act, leaving the full limit under the Class Order available for issues to other employees.

GOVERNMENT VIEW

It is noteworthy that the announced amendment to the ESS taxing provisions follows on from the release in November 2020 of the revised draft of CPS511 (and more recently supported by CPG511) which will apply to entities regulated by the Australian Prudential Regulatory Authority (APRA). Paragraph 41 states:

> *"An APRA-regulated entity must not accelerate the vesting of unvested variable remuneration for a person in a specified role no longer employed or engaged by the entity, unless specific exceptions have been included in the remuneration policy. If that person is eligible for any unvested variable remuneration, it must be subject to the same vesting conditions as those for a person employed or engaged by the entity."*
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> *"a reference to 'specific exceptions' is limited to death, serious incapacity, serious disability, serious illness or partial vesting of only the amount required to enable the person to cover taxation obligations arising from the deferred variable remuneration at termination."*

Clearly the government's view as evidenced by CPS511 is that:

a) Termination of employment should not be a trigger for accelerated vesting, and
b) vesting should be applied consistently for both continuing and former employees, and
c) accelerating, forfeiting or vesting at termination of employment undermines the long term alignment and risk management impacts that are intended to arise from this type of remuneration.

The proposed amendment to the ESS taxing provisions will support compliance with the Government's view. Although the view is currently confined to APRA regulated entities it may be expected that it will be seen as good policy by other companies and will be adopted by them in the near future.

CONCLUSION

The change to the ESS taxing provisions means that ASX listed companies should review the following and ensure that they are optimised:

- LTVR Plan Rules,
- LTVR Policy & Procedure,
- STVR Plan Rules insofar as relevant to deferral and Clawback & Malus,
- STVR Policy and Procedure insofar as relevant to deferral and Clawback & Malus,
- Minimum equity holding policies, which GRG recommends counts vested but unexercised equity (a view that seems to be accepted by most governance commentators), and
- Malus & Clawback Policy.

It should be noted that adopting this approach logically aligns with the modern view that when LTVR is granted every year, it is "earned" by the end of the year in which it is granted, as part of an annual Total Remuneration Package i.e. GRG proposes that under the foregoing approach, the only forfeiture that occurs at termination is to reflect the period of that financial year that will not be served, with prior year grants remaining on foot to support long term alignment, malus and clawback at a material level. This also has the advantage of simplifying accounting treatment, such that the grants will be fully expensed in the year in which that are granted.