# GRG Remuneration Insight 120

# Unlocking the Secret to Long Term Alignment

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## Introduction

Many stakeholders, including regulators, want executives to have large, long retained equity holdings in their employers, yet many obstacles appear to stand in the way of this objective being achieved. This usually prevents interested stakeholders (boards, executives and shareholders), from finding a solution, and instead we often see key management personnel disposing of equity as soon as it vests to pay down a tax liability that has unnecessarily arisen, and exposing them to Australian Securities and Investments Commission (ASIC) scrutiny.

This GRG Remuneration Insight identifies the obstacles and offers practical solutions to enable long term equity holding that underpins genuine long term alignment, well beyond the 3 years of a typical long term variable remuneration scheme.

## The Right Way is Indeterminate

The 'Right' (equity instrument) being referred to in this Insight is an entitlement on valid exercise to the value of a share in the employer company (Share) that may be settled in cash or a Share as determined by the Board. Such Rights are not regarded as securities for Corporations Act purposes, as they are "indeterminate" (a type of derivative), meaning that their nature cannot be determined until they are settled. Thus, they do not qualify for disclosure relief under s708 of the Corporations Act.

They can qualify for various forms of relief under ASIC Class Order (CO) 14/1000 which applies to listed companies (a similar but more restricted CO14/1001 applies to unlisted companies, but the below addresses CO14/1000 only), provided certain conditions are satisfied including:

1. ASIC is notified when CO14/1000 is first relied upon,
2. Total grants relying upon CO14/1000 during a rolling 3-year period must not exceed 5% of issued Shares, and
3. The Rights cannot be granted under a contribution plan which includes salary sacrifice arrangements. This is generally taken to include voluntary deferral arrangements where the participant could reasonably expect to receive a cash equivalent if they did not enter into the arrangement (note: if salary sacrifice arrangements are preferred GRG can offer a solution).

Many ASX 100 companies are already using this type of instrument because of the tax and termination benefit limit advantages it conveys i.e. it is a well-tested with a high degree of certainty regarding the tax, legal and other compliance outcomes.

## Three Main Vehicles for Accumulation of Equity

The three main vehicles by which executives can accumulate equity stakes in their employer are:

1. Long term variable remuneration (LTVR),

2. Deferral of short term variable remuneration (STVR) awards, and
3. Delivery of part of Fixed Pay in the form of equity which is an increasingly popular practice, often done in lieu of a cash increase (i.e. it is not a voluntary arrangement, but is contracted).

Some companies may also have an employee share scheme arrangement that allows executives to acquire $1,000, $5,000 or even unlimited amounts of equity, usually on a salary sacrifice basis. Only the latter will generally be meaningful in terms of building a stake in an employer. GRG can advise on unlimited salary sacrifice general employee equity plan designs, if required.

## Taxation of Rights in Australia

Australian taxation of Rights is governed by the employee share scheme (ESS) taxing provisions when on exercise of the Rights they are settled in Shares. The main factors that influence the taxing point under the ESS taxing provisions are:

- Vesting conditions which can be service and/or performance related – often referred to as a "real risk of forfeiture", and
- Disposal restriction that can be applied to Rights and to Shares acquired on exercise of Rights.

In a practical sense, whether or not the plan allows for manual exercise or automatic exercise at vesting or a specified date will often influence when Rights become taxable as exercise is the point that settlement will be determined (i.e. they cease to be indeterminate). In companies that pay dividends, exercise will often be automatic so that participants do not miss out on dividends declared after the vesting date. In companies that do not pay dividends, it is generally advantageous for exercise to be manual, allowing the Participant to choose their taxing point up to a maximum of 15 years after the grant date (subject to termination, see comments below).

If vesting conditions apply to Rights then, in the absence of disposal restrictions, the taxing point is when the Rights vest.

If vesting conditions and valid disposal restrictions are attached to the Rights when they are granted, then the taxing point is deferred until the disposal restrictions cease to apply which generally means that the taxing point becomes when the Rights are exercised.

If vesting conditions and valid disposal restrictions are attached to the Rights when they are granted and apply to both the Rights and to Shares to be acquired on exercise of Rights, then the taxing point is deferred until the disposal restrictions cease to apply which will be subsequent to the exercise of the Rights and may be many years later.

Alternatively, if Rights are not subject to vesting conditions but are subject to valid disposal restrictions and the plan rules acknowledge that Subdivision 83A-C of the Income Tax Assessment Act 1997 is to apply to grants of Rights then the taxing point will be when the disposal restrictions cease to apply which will generally be when the Rights are exercised. This taxing point may be further delayed if disposal restrictions apply to the Shares to be acquired on exercise of the Rights are specified when the Rights are granted. In such cases the taxing point is deferred until the disposal restrictions cease to apply to the Shares.

The maximum tax deferral period is until the earlier of cessation of employment and the elapse of 15 years after the grant of the Rights. Thus, even if vesting conditions or disposal restrictions extend beyond these points then the application of ESS tax will ultimately be determined to be at these points.

If Rights are settled in cash on exercise then the cash received will be taxed in the year it is received i.e. the ESS tax treatment does not apply and income tax will apply as if it was salary.

When Rights are not exercised until after a cessation of employment or elapse of 15 years it is not possible to determine which are the appropriate taxing provisions until the form of settlement is determined by the Board. If in Shares then the value of the Rights at the date of the cessation of employment or elapse of 15 years becomes taxable and prior year tax returns may need to be amended. A shortfall interest charge may be applied to the amended increase in tax that would have been due in the relevant year had the nature of the Rights been known at the time.

If Rights are not exercised until after cessation of employment it is possible that the Share price may have fallen by the time the Rights are exercised. In this situation an executive may face a tax liability on an amount which is greater than that for which the Shares may be sold. In the worst case the value of the Shares may be less than the amount of tax to be paid. To avoid such problems boards may exercise their discretion to settle in cash, thereby addressing this problem.

While these provisions may appear complex they offer opportunities to more effectively use Rights to ensure that executives build larger equity stakes in their employers and hold those stakes for long periods, including post cessation of employment.

## Companies Not Paying Dividends

For companies that do not pay dividends the use of Rights can be very simply implemented, since tax can be deferred until exercise, and there is no incentive to exercise the Rights until dividends begin to be paid. On the contrary, there is an incentive to hold as long as possible since the more growth is achieved before taxation, the greater the ultimate benefit of the ESS taxation treatment. Thus, executives can be provided with Rights as LTVR grants, deferred STVR awards or grants as part of Fixed Pay and the executives will not need to sell to pay tax until they exercise the Rights.

A key element of this approach is that the disposal restriction on the Rights must be genuine which means that the Board cannot have discretion to waive the disposal restriction. Unfortunately, such discretion is often included in plan rules which means that this approach cannot be implement under many LTVR plans.

## Companies Paying Dividends

A common practice when companies calculate the number of Rights to be granted to executives is to divide the amount of LTVR, deferred STVR or the equity element of Fixed Pay by the Share price (usually calculated as a VWAP). This is fundamentally incorrect as the executives are not receiving Shares, they are receiving Rights. There is a difference between the value of a share and the value of a Right. That difference is determined by reference to the dividends that will not be received by the executive during the period before the Rights are exercised. That this is the correct value difference can be validated by applying the Black-Scholes Option Pricing Model to value Rights, noting that a nil exercise price cannot be used in the Model, therefore a minor fraction of a cent needs to be used as the exercise price.

When the value of the Right is used as the divisor the executive receives more Rights to compensate for not receiving dividends. Thus, provided that the period used in the Right valuation formula is the same as the period that Rights are held by the executive before exercise, the executive will not have been disadvantaged by not receiving dividends. Therefore, the executive can retain the Rights and delay exercise and taxing until the end of the period. Despite the claims of some commentators, the executive is not advantaged, as only the value of dividends associated with Rights that vest will flow to them.

By combining long periods in Rights valuation formulae with innovative vesting scales and exercise or disposal restrictions it is possible to allow executives maximum flexibility to determine when to exercise Rights and not produce excessive vesting of Rights. In addition, it can enable companies to apply holding locks on Rights for extended periods without disadvantage for executives. This could even extend beyond termination of employment which would create the kind of genuine long term decision making and succession focus that many stakeholders are calling for.

Another point to note is that the Rights granted to replace dividends are calculated at the time of grant of the Rights and therefore do not grow as dividends grow. However, if there is growth in the value of the Shares that will be acquired by exercising Rights this should compensate executives and provide a means by which executives can be kept whole in relation to dividend value. A pleasing feature of this outcome is that ultimate dividend replacement value is then linked to company performance and share price movement which increases the performance alignment of the Rights.

## Observations and Conclusions

Some large listed companies are already achieving long term equity holdings for non-executive directors (NEDs) but in a far less flexible way. NEDs are provided with Rights that convert into Restricted Shares

that cannot be disposed of until they cease to hold office. NEDs have been the focus of this approach because it is generally seen as inappropriate for them to be transacting on market, even to sell to pay tax, therefore maximum tax deferral is preferred. If this is appropriate for NEDs, why isn't such long term holding and minimisation of market signalling (or ASIC scrutiny risk) an appropriate standard for executives as well?

Given APRA's proposals to extend the deferral period, in some cases for up to seven years, in relation to variable remuneration, it is timely for the financial services sector to reconsider the way it is using Rights to defer variable remuneration. Rights as outlined in this Insight will enable:

1. Long term deferral of variable remuneration into equity for periods that can extend beyond cessation of employment,
2. The deferred amounts to be keep available for clawback, if required,
3. The value of the deferred amounts to be linked to company performance,
4. Executives not to be disadvantaged by lack of entitlement to dividends as holders of Rights.

The longstanding problem of CEOs and other senior executives not being able to sell Shares despite tax needing to be paid on vested LTVR, deferred STVR or other equity grants may be overcome with new approaches to granting, vesting and exercise of Rights. Tax will not become payable until an executive can sell Shares.

The preferences of proxy advisors and other stakeholders for executives to hold significant equity over their tenure can more easily be accommodated with appropriately structured Rights.

In order to action this approach, a review of equity plan opportunities should be conducted in respect of:

- Sources of acquisition, including salary sacrifice alternatives,
- The required references to Subdivision 83A-C of the ESS taxing provisions,
- The nature of the Right, whether it is indeterminate or not,
- Manual exercise vs automatic exercise,
- The strength of disposal restrictions applicable to Rights,
- The ability to impose exercise restrictions and tax effective disposal restrictions that extend to Shares that flow from the exercising of Rights,
- The methods by which disposal restrictions on Shares are enforced (must be a CHESS holding lock or held in a trust), and
- The method of calculation of grants of equity.

GRG has many years of experience advising on innovative equity plan designs and drafting implementation documentation that is tax effective for participants. Please do not hesitate to contact us for further information.