GRG Remuneration Insight 124

Rights Plans Better than Share Purchase Loan Plans

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Introduction

This GRG Remuneration Insight compares the Share Purchase Loan Plan (SPLPs) with a Rights Plan. The trigger for making such a comparison has been that SPLPs are often believed to be more tax efficient for executives than Rights Plans. The basis of the claim seems to be founded in the fact that under SPLPs share price gains are generally tax free as to 50% of the gains under the capital gains tax (CGT) provisions whereas such gains in respect of Rights are 100% taxed under the employee share scheme (ESS) taxing provisions. This Insight seeks to debunk that commonly held belief.

Share Purchase Loan Plan

SPLPs were many years ago the main form of employee share scheme in Australia. However, since the introduction of AASB2 Share-based Payment, the accounting standard for expensing various equity arrangements with employees, the use of SPLPs has almost disappeared. Prior to AASB2 there was no accounting charge for equity plans but there is now a substantial charge that reduces company profitability. The other factor was that Rights became the preferred equity instrument due to simplicity of administration and understanding by participants.

The basic features of an SPLP are:

1. Loans are provided to employees to fund the full purchase price of company shares.
2. The purchase price of the shares is the market value of the shares, i.e. no discount.
3. The loans are interest free and non-recourse (also referred to as limited recourse) i.e. the liability for repayment of the loan is limited to the value of the shares purchased.
4. Net of tax dividends are applied to repay the loan.

Thus, the SPLP operates much like an option plan except for the receipt of dividends which effectively reduces the cost of the shares.

As the shares are acquired at market value there is no discount in the acquisition price and therefore the ESS taxing provisions do not apply. No tax is payable, except on dividends, until the shares are sold and then any gain or loss is taxed under the CGT provisions. If the shares have been held for more than 12 months, employees are taxed on 50% of the gain and the other 50% is tax free.

Rights Plan

Under Rights Plans employees are granted Rights which when exercised are normally converted into one share for each right exercised. The Rights are taxed under the ESS provisions and the taxing point is typically on exercise or subsequent cessation of disposal restrictions that were attached to the shares acquired on exercise of the Rights. The full value of the shares is the value that is taxed at the taxing point. The 50% CGT concession does not apply.

Points of Differentiation between Rights and SPLPs

There are several points of differentiation between Rights and SPLP acquisitions including:

a) Rights confer the full value of a share whereas SPLP acquisitions confer the growth in value of a shares plus dividends which represent a minor part of the value of a share over the period that most loans persist.

b) Tax is a consequence of the sale of SPLP shares whereas ESS tax on Rights is usually triggered prior to the sale of shares acquired on exercise of Rights but the tax liability in turn tends to trigger a sale of shares.

c) SPLPs are administratively cumbersome and may impact an individual's capacity to borrow personally whereas Rights are administratively simple and have no impact on an individual's capacity to borrow personally.

d) Companies do not receive any tax deduction for the AASB2 expense of providing SPLP benefits. Under a typical SPLP the SPLP acquisition is valued under AASB2 as if the arrangement were an option and then that value is expensed over the service vesting period.

e) If the loans are interest free and the company is not paying dividends, then fringe benefits tax (FBT) may be payable by the company on the interest saving by the employee. Rights are not subject to FBT.

f) Companies receive a deduction in respect of Rights at the time the Rights are exercised. This is achieved via the use of employee share trusts (ESTs). The tax deduction that results is equal to the benefit provided to the employee at the time of exercise i.e. the value of the shares. This deduction often exceeds the value of the Rights granted and generates a significant benefit for the company reducing the cost of the Rights Plan.

Cost to Company

In order to compare the two alternative approaches to providing equity as a component of remuneration it is essential to start with the same cost to the company. In this regard tax is an important cost component. Thus, the basis on which cost to the company should be assessed is after tax cost.

A possible exception is in relation to companies that are making losses that are unlikely to be recovered in the foreseeable future. For such companies, the before tax cost may be a more relevant basis of comparison.

Comparison of Rights Plans and SPLPs

The table on page 3 presents the typical way of calculating the number of Rights or shares under an SPLP based on a remuneration value of $100,000 to be provided. Both Rights and shares are valued using a Black-Scholes Option Pricing Model and the number of shares or Rights to be offered is calculated by dividing the Equity Value of Grant by the value of the instrument being offered. Assumptions used in the Black-Scholes Model include: risk free interest rate of 1% and volatility of 40%. In Model 1 the calculations to determine the numbers to be offered are as follows:

Number of Rights to be Offered	=	Equity Value of Grant ÷ Right Value
	=	$100,000 ÷ $8.52
	=	11,737

Number of Shares to be Offered	=	Equity Value of Grant ÷ Option Value (Note that SPLPs are valued as options)
	=	$100,000 ÷ $3.86
	=	25,906

Models 1, 2 and 3 are based on variations in the mix of share price growth and dividends but achieving approximately a 10% pa return to shareholders, which is the ASX long term average annual total shareholder return (TSR). These three models cover a range of possible scenarios likely to be encountered by many ASX listed companies. Model 4 looks at exceptional share price growth at an annual compound growth rate of 20% plus 3% dividends. All dividends are assumed to be fully franked.

Observations in relation to the Models include:

1. There is no material difference between the net benefits provided from either Rights or the SPLP in models 1,2 and 3.
2. Under Model 4 the SPLP produces much larger net of tax benefits for employees.
3. The company cost of each alternative is approximately the same on a before tax basis i.e. $99,999 for Rights and $99,997 for the SPLP.
4. The after-tax cost of the two alternatives is materially different due to there being no tax savings under the SPLP and the tax savings under the Rights Plan growing as the share price increases. In each Model the after-tax cost of the Rights Plan is substantially lower than the cost of the SPLP.
5. If the cost to the company is equal under both the Rights Plan and the SPLP then the Rights Plan will always produce greater benefit for employees.

Having regard to the foregoing analysis and the additional administrative complexity of the SPLP, the SPLP is a significantly inferior plan compared to the Rights Plan.

Assumptions	Model 1	Model 2	Model 3	Model 4
Share Price & Exercise Price	$10.00	$10.00	$10.00	$10.00
Value of Right	$8.52	$9.23	$10.00	$8.86
Option Value of SPLP	$3.86	$3.54	$3.24	$3.70
Equity Value of Grant	$100,000	$100,000	$100,000	$100,000
Holding Period	4	4	4	4
Franking Credit %	100%	100%	100%	100%
Company Tax Rate	30%	30%	30%	30%
Personal Tax Rate	47%	47%	47%	47%

Employee Position	Rights	SPLP	Rights	SPLP	Rights	SPLP	Rights	SPLP
Share Price Growth Rate pa	6%		8%		10%		20%	
Annual Dividend	$0.40		$0.20		$0.00		$0.30	
Number of Rights or Shares	11,737	25,906	11,737	25,906	11,737	25,906	11,737	25,906
Share Price at End	$12.62	$12.62	$13.60	$13.60	$14.64	$14.64	$20.74	$20.74
Share Benefit	$148,177	$67,997	$159,681	$93,388	$171,841	$120,230	$243,378	$278,127
ESS Tax	$69,643		$75,050		$80,765		$114,388	
CGT		$15,979		$21,946		$28,254		$65,360
Net Benefit Shares	$78,534	$52,018	$84,631	$71,442	$91,076	$91,976	$128,991	$212,767
Gross Cash Dividend Benefit		$41,450		$20,725		$0		$31,087
Gross Franking Credit		$17,764		$8,882		$0		$13,323
Taxable Dividend Value		$59,214		$29,607		$0		$44,410
Tax on Cash Dividends		$10,066		$5,033		$0		$7,550
Net Cash Dividends		$31,383		$15,692		$0		$23,537
Total Net Benefit TNB)	**$78,534**	**$83,401**	**$84,631**	**$87,134**	**$91,076**	**$91,976**	**$128,991**	**$236,304**
Benefit if Cost of Rights = Cost of SPLP	**$141,381**		**$162,450**		**$187,986**		**$477,982**	

Company Cost	Rights	SPLP	Rights	SPLP	Rights	SPLP	Rights	SPLP
Accounting Charge	$99,999	$99,997	$99,999	$99,997	$99,999	$99,997	$99,999	$99,997
Tax Deduction	$44,453	$0	$47,904	$0	$51,552	$0	$73,014	$0
Net of Tax Cost (NTC)	**$55,546**	**$99,997**	**$52,095**	**$99,997**	**$48,447**	**$99,997**	**$26,986**	**$99,997**

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