# GRG Remuneration Insight 147

## Why Share Appreciation Rights (SARs) Will Replace Options and Share Purchase Loan Plans

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### Introduction

In this Insight we explore the significant advantages offered by share appreciation rights (SARs); a modern alternative to traditional options or share purchase loan plans (SPLPs), which should now be considered the superior leveraged variable remuneration plan instrument following the changes to the Corporations Act that came into effect from 1 October 2022. Options and other leveraged option-like structures, which can be argued to include SARs and SPLPs, remain a valuable instrument for companies expecting significant future share price growth. The low grant value and exponential intrinsic value that flows from such leveraged products can be very attractive. However, from 1 October 2022, new ESS provisions reclassified options and SPLP structures as "contribution plans" that are now subject to significant regulatory and disclosure requirements, as well as strict limits. Therefore, any company currently operating or considering an option plan should consider switching to SARs; the financial benefits to the participant and the cost to the company remain identical, with the added benefit of SARs being typically 50% to 80% less dilutive, with significantly reduced expense and administrative burdens. The only remaining case for options to be issued into the future is where special tax exemptions apply i.e. either options with such a high exercise price that they have a nil taxable value, or in unlisted companies that qualify for the start-up tax concessions.

### What is an Option?

An Option is a security which represents an entitlement to a share upon the option holder exercising the option and paying the "exercise price". There are multiple variations of options defined by how the exercise price is set.  They are generally related to the expected share price growth rate. Variants include market exercise priced options (MEPOs) which are the dominant form of option, Premium exercise priced options (PEPOs), which can enjoy special tax treatment, and discounted exercise priced options (DEPOs) which are exceptionally rare.

An option may be subject to vesting conditions that must be satisfied before vesting, such as service and/or performance conditions. It is common for options to have no vesting conditions attached as they are often considered to have an intrinsic share price hurdle, set by the exercise price; if the share price does not materially exceed the exercise price, then the intrinsic value is close to or equal to nil and therefore, there is no reason to exercise them.  Zero exercise priced options (ZEPOs) are more commonly referred to as Rights and are not considered options for the purposes of this discussion and regulations being addressed, because they do not usually involve a "contribution" by the participant, since the exercise price is nil.

### What is a Share Appreciation Right (SAR)?

A SAR is a derivative and is simply a "cashless exercise" option. It is also common for a SAR to be able to be settled in cash rather than shares if so desired by the Board. SARs can be constructed to have identical terms and benefits to their traditional option counterparts. However, on settlement of a SAR, the exercise price is deducted from the share price, and the aggregated net value of exercised SARs is settled in shares (or cash if so desired). The participant generally receives a number of shares calculated as follows:

| *Shares Received* | = | *(Share Price – Exercise Price) x Number of Exercised SARs ÷ Share Price* |
|---|---|---|

SARs are, therefore, classifiable as "indeterminate" for tax purposes because there is no 1:1 relationship between the number of SARs and the number of shares that will be received (see advantages, below).

## When are Leveraged Structures like SARs, SPLPs or Options Used?

Because of the presence of an exercise price, whether or not it has to be paid or is simply deducted from the net benefit to be settled, leveraged structures like SARs, options or indeed SPLP's are generally only deployed in one of the following scenarios:

1. **High share price growth is expected**: because these structures have a marginal value at all times (excess of the share price over the exercise price), they have a low intrinsic value to start with and are usually granted in much higher numbers than un-leveraged structures. As the share price grows, the value accruing to the holder becomes exponential. For example, a typical MEPO held for 3 years, the share price growth rate generally needs to exceed 17.5% per annum compounding, in order to produce more benefit than non-leveraged structures like a Right. For options (only) if the exercise price is set sufficiently above the share price, they can be designed to be taxable up-front, at a taxable value of nil and thereafter any gain would be taxable as a capital gain and possibly qualify for the 50% capital gains tax (CGT) concession.
2. **There are significant shareholder participants that cannot access Employee Share Scheme (ESS) tax deferral and/or wish to access CGT treatment from day 1**: in the case of businesses with participants who are founders or significant shareholders (own, control or can direct the voting of 10% or more of the company's shares), equity plans can present a challenge, because they cannot access tax deferral. Instead, ESS interests will be taxable at grant, the payment of which cannot be funded from the equity received. SARs on the other hand cannot be assessed for tax purposes until they have been exercised, providing effective tax deferral (though eventually the tax liability may be backdated if settled in shares). SARs can also be structured such that they are subject to CGT treatment from day 1, if so desired. SPLPs also offer no taxable value at grant for such participants, and provide leveraged returns equivalent to options, as well as CGT treatment from day 1.
3. **The company is unlisted and qualifies for start-up concessions:** there is a special tax provision for "start-ups" (unlisted companies that have existed for less than 10 years and have not reported more than $50m in turnover in the prior year). This provision is extremely attractive because it offers a "safe harbour" valuation method that is often a deep discount to the true share price, and tax will not have to be paid until the underlying shares are sold, at which point CGT will apply to the excess of sale price over the exercise price.

In all other scenarios, an Option, SPLP or SAR will produce an inferior outcome compared to alternatives such as Rights, which are also subject to significantly lesser regulation, disclosure conditions and limits.

## Advantages of SARs over Options and SPLPs

SARs produce an identical net benefit for the participant compared to options with identical terms, however there are a number of advantages that SARs offer over options that make them the superior choice, except in the cases of PEPOs and scenario 3 ("start-up" plans) outlined above. The advantages include the following:

1. SARs are typically 50% to 80% less dilutive than options with the same terms, while providing an identical net benefit,
2. Participants do not face the challenges or costs associated with paying the exercise price,
3. Smaller volume sales into the market result from SARs (market signalling risks),
4. Advantageous tax treatment for significant shareholder participants can be obtained from SARs,
5. Unlike options or an SPLP, SARs are not considered "contribution plans" under the newly amended Corporations Act. This relieves companies from disclosure requirements and removes limits on the number that can be issued, in relation to the Corporations Act ESS framework.

### *Much Less Dilutive compared to Options*

When Rights, SARs or options are exercised, companies may provide shares to participants via on-market purchases, or through the issue of new shares. While some shareholder groups may prefer on-market purchases, the issue of new shares is generally the most cost-effective approach from a company

perspective because there is no net cash outflow. This ultimately benefits shareholders also. However, this approach results in the dilution of share value for existing shareholders which can be undesirable, especially when the number of shares involved is high, such as typically applies to options which are often issued in comparatively large numbers due to their marginal, low relative value. In the case of options, a 1:1 relationship with shares applies on exercise, whereas SARs do not have a 1:1 relationship with shares on exercise, even though the same number of SARs and options are initially granted. This is because of the cashless exercise feature; only the net benefit needs to be settled in shares, which is generally a fraction of the number of options or SARs issued. In general, SARs are 50% to 80% less dilutive than options, depending on the share price growth rate and the period prior to exercise.

The following tables model the net benefit and dilution impact of both SARs and options, assuming a typical MEPO structure has been used:

| General Assumptions | Value | Options/SARs Assumptions | Value |
|---|---|---|---|
| Price at Grant | $1.00 | Exercise Price MEPOs | $1.00 |
| Years Held | 4.00 | Risk Free Interest Rate | 3.920% |
| Share Price Compound Annual Growth Rate | **17.5%** | Volatility | 50% |

| Aspect | Variables | Options | SARs |
|---|---|---|---|
| **Equity Value to Grant** | | **$100,000** | **$100,000** |
| Value of Instrument at Grant (Black-Scholes Value) | | $0.30 | $0.30 |
| Number Granted | | 330,431 | 330,431 |
| Share Price at End/Sale (17.5% CAGR) | $1.91 | $629,842 | $629,842 |
| | | | |
| Exercise Price Paid | | $330,431 | $0 |
| Gross Benefit Net of Exercise Price | | $299,412 | $299,412 |
| ESS Tax | | $140,723 | $140,723 |
| **Net Benefit** | | **$158,688** | **$158,688** |
| Tax Deduction Saving for Company | | $89,823 | $89,823 |
| **Net Company Cost** | | **$10,177** | **$10,177** |
| Dilution/Shares Issued | | 330,431 | 157,079 |
| **Relative Dilution** | | 100% | 48% |

The preceding model presents an outcome of SARs being 52% less dilutive than options with the same terms, while providing an identical benefit. However, the dilution relativity will ultimately depend on the share price growth rate. At lower growth rates SARs will be even less dilutive, down to close to nil dilution at very low growth rates, while options would still involve 330,431 new shares being issued for very little benefit. Dilution of SARs will be higher than modelled at higher growth rates, but SARs will never be as dilutive as options with the same terms, in any scenario.

It should be noted that some readers may argue that the net benefit is not identical in this model, because the participant ends up with 157,079 shares under the SARs approach, but 330,431 shares under the options approach. Nevertheless, the difference is equal to the number of shares that the option holder needs to sell to repay the exercise price, and this is in fact what happens in the vast majority of cases. Some may argue that they can fund the exercise price from a source other than selling the shares received, but this would introduce additional/external funds into this model, rendering the comparison invalid. In such a scenario, the participant could have invested those additional/external funds into shares, and experienced additional returns under a SARs approach, which would produce a higher net benefit under the SARs model. Thus, SARs would seem to be the superior choice for all stakeholders.

### *Participants are not required to pay an Exercise Price for SARS*

The defining feature of an option is that participants are required to pay the exercise price in order to convert the options into shares. This requirement can be onerous and expensive for participants, with external funding or loans being required; often subject to high interest rates and fees despite the low risk and short term nature of the funding. In the example above, the participant must pay an exercise price of

$260,424 to exercise the options which is likely to be challenging to fund externally even for most executives. The company then needs to accept and process these contributions, which includes an administrative burden and cost. When using SARs, these transactions are not necessary as the exercise price is accounted for when calculating the net benefit, reducing cost and administration for all stakeholders. This would seem to be in the interests of all stakeholders.

***Smaller Sales into the Market (market signalling risk)***

In case of options, the participant will typically need to sell sufficient shares into the market to repay the source of funding of the exercise price. This sale usually represents the majority of shares received, which ultimately renders the issue/receipt of such shares redundant, and risks undesirable market signalling. When share price growth rates are low, only a small fraction of the shares received will be retained, due to the need to fund the exercise price. This can send the message that the participant does not have faith in the company, which is not in the interests of any stakeholder, and again SARs appear to be the superior alternative.

***Tax deferral advantages for Shareholders with 10% or more interest***

Participants who are significant shareholders – those who hold or can vote 10% or more of the company's shares, are not entitled to the same tax deferral benefits as other employees, under Section 83A-C of the Income Tax Assessment Act. This means that generally tax must be paid up-front on options. This is not the case for SARs because they are classified as "indeterminate", and the ATO cannot assess the ESS taxable value, if any, of the instrument until they have been exercised. At that point, if paid in shares, the tax assessment will be backdated to the date of grant (requires amendment of previous tax return), and a shortfall interest charge may apply, but CGT treatment will also apply to any growth, which is a major tax advantage. In addition, SARs can be settled in cash which may be preferable when the share price growth is small and the ESS tax and the shortfall interest charge would erode or exceed the share price growth. Deferring the taxing point of ESS interests (i.e., a Right or option) until the point when they are exercised into Shares yields numerous benefits to participants without disadvantaging the company. Such benefits include maximising the flexibility of when participants can elect to exercise their ESS interests and trigger the taxing point (up to a maximum of 5 years from the grant date for option-type structures for listed companies). This is the only scenario where CGT treatment will produce superior benefits to ESS tax treatment; see Insight 133: The Myth of CGT Tax Advantages.

***Classified as a non-contribution plan under new Corporations Act legislation (disclosure relief)***

Prior to 1 October 2022, SARs and options enjoyed similar disclosure relief and treatment under the Corporations Act. However, under the new ESS framework described in the Corporations Act (Division 1A of Part 7.12 as amended by ASIC's recently drafted legislative instrument), circumstances have drastically changed. Because an exercise price has to be paid, options are now classed as "contribution plans" under s1100Q. As such, onerous additional regulations, limits and disclosure requirements apply, which do not apply to SARs since they are not classifiable as "contribution plans". The challenges of issuing options are different for listed and unlisted companies, but of note are the following to consider in relation to "contribution plans":

1. Disclosures must be made to participants unless they are a "senior manager" or otherwise exempt from disclosure requirements under s708 of the Corporations Act. This is not onerous for listed companies but is often onerous, even a "deal-breaker", for unlisted companies.
2. The number of rights or options the company can issue is limited to a specified percentage of the company's shares over 3 years:
    a. 20% for unlisted companies,
    b. 5% for listed companies.
3. For unlisted companies, the maximum amount that can be offered to a participant is $30,000 per year, plus 70% of distributions plus 70% of cash bonuses, paid in the period (the monetary cap relates to the aggregate exercise price across the options offered, and/or aggregate acquisition price).
4. Refer to the Corporations Act for further information regarding compliance requirements.

**Conclusion:** except in the case of start-ups, or where the exercise price can be at such a premium to the share price that nil-up-front-tax applies, SARs should replace all option plans from 2023 onwards.