GRG Remuneration Insight 151

Premium Options Boost Pay

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PEPOs are a tax-efficient, cost-effective way to provide employee equity

ASX listed companies with high growth potential but limited cash resources often ask what can be done on the remuneration front to help compete for scarce talent at all employee levels whilst maximising tax efficiency and minimising cash or accounting costs. Unlisted companies can, of course, often qualify for the Employee Share Scheme (ESS) start-up tax concession. However, listed companies do not qualify for this concession.

An alternative that may be considered is to grant Premium Exercise Priced Options (PEPOs) which are options with an exercise price set at a premium to the market share price when the options are granted.

Value of Options for Accounting Purposes

The value of options for accounting purposes (AASB2) can be calculated using various option pricing models. One such model is the Black-Scholes Option Pricing Model (BSOPM). The elements in the formula are:

- Share Price i.e., the market value of a share at the time the option is granted, (assumed to be $1.00),
- Exercise Price i.e., the amount that must be paid to exercise the option,
- Option Price i.e., the amount payable for the option, usually nil, (assumed to be nil),
- Term of the option i.e., the period within which the option must be exercised, or it will lapse,
- Risk free rate of return i.e., the 10-year government bond yield rate, (assumed to be 4%),
- Dividend yield (assumed to be 4%), and
- Volatility of Share Price (assumed to be 60%).

Assuming volatility as a given, the two main elements that can be adjusted to change the value of an option are the Exercise Price and the Term. The following matrix shows the market value (calculated using the BSOPM) of options granted with different Terms and Exercise Prices. The Exercise Prices have been selected based on percentage premiums close to optimal points in the valuation tables provided in the Income Tax Regulations – discussed later. The life of the options has been assumed to be the Term of the options:

Market Value of an Option							
		Exercise Price					
		$1.00	$1.18	$1.25	$1.34	$1.43	$1.70
Term	1	$0.227	$0.170	$0.152	$0.132	$0.114	$0.076
	2	$0.303	$0.253	$0.237	$0.218	$0.200	$0.157
	3	$0.352	$0.308	$0.293	$0.276	$0.259	$0.218
	4	$0.385	$0.346	$0.333	$0.317	$0.302	$0.264
	5	$0.407	$0.373	$0.361	$0.347	$0.334	$0.299

For purposes of this Insight, the impact of market vesting conditions on accounting valuations have been ignored because for grants of options to employees generally, it would be expected that performance vesting conditions would not be applied.

It should be clear from the matrix that:

- as the Term becomes shorter the option value becomes lower, and
- as the Exercise Price increases the option value becomes lower.

Thus, by reducing the Term and increasing the Exercise Price ,the value of options can be significantly reduced.

If 10,000 options were to be granted to each employee, then the accounting cost per employee would be as follows:

Accounting Value of Tranche of Options							
10,000							
Term	1	$2,270	$1,700	$1,520	$1,320	$1,140	$760
	2	$3,030	$2,530	$2,370	$2,180	$2,000	$1,570
	3	$3,520	$3,080	$2,930	$2,760	$2,590	$2,180
	4	$3,850	$3,460	$3,330	$3,170	$3,020	$2,640
	5	$4,070	$3,730	$3,610	$3,470	$3,340	$2,990

The above costs are relatively low, when compared to the accounting expense of granting 10,000 shares or rights which would have an accounting value of $10,000. The green highlighting relates to structures that are expected to be assessed as having a nil taxable value (as shown in the following sections).

Potential Benefits for Employees

The following table presents various scenarios for share price growth - and the benefits that may be derived by employees from a grant of 10,000 options with various example Exercise Prices. Of course, each company's realistic expectations of Share Price growth will be influenced by their specific circumstances. The Share Price growth scenarios represent outstanding Share Price growth performance within the Term of the options.

Benefit fromTranche of Options							
			Number of Options	10,000			
				Exercise Price			
		$1.00	$1.18	$1.25	$1.34	$1.43	$1.70
End Share Price	$1.00	$0	$0	$0	$0	$0	$0
	$1.50	$5,000	$3,200	$2,500	$1,600	$700	$0
	$2.00	$10,000	$8,200	$7,500	$6,600	$5,700	$3,000
	$2.50	$15,000	$13,200	$12,500	$11,600	$10,700	$8,000
	$3.00	$20,000	$18,200	$17,500	$16,600	$15,700	$13,000
	$3.50	$25,000	$23,200	$22,500	$21,600	$20,700	$18,000
	$4.00	$30,000	$28,200	$27,500	$26,600	$25,700	$23,000

Regulatory Challenge for Unlisted Companies

Unfortunately, under Division 1A of Part 7.12 of the Corporations Act, PEPOs are considered "contribution plans" which may make it challenging to offer the structures beyond "senior managers" in unlisted companies. See https://www.grg.consulting/new-employee-share-scheme-regulatory-framework-finalised/.

Employee Share Scheme Taxation Value

When options are granted under an ESS, any discount is included in the employee's assessable income unless one of the exemptions, concessions, or deferral provisions apply. The amount of discount is the shortfall of the amount paid for the option relative to the taxation value of the option.

Under Income Tax Regulation 83A.315.01 employees may, in relation to unlisted options that have Terms less than 15 years, choose to use either:

a) the market value of the option i.e., the accounting value, or
b) the value calculated pursuant to the Regulations,

when valuing the options for taxation purposes. The valuation approach used in the Regulations tends to produce values that are significantly lower than accounting values. The following matrix presents taxation values for the same options previously valued for accounting purposes. It should be noted that options with an exercise price greater than nil, typically have a life/term of 5 years (rarely more) due to the value of the option inflating significantly beyond this period.

ESS Taxation Value of Tranche							
10,000							
Term	1	$290	$14	$0	$0	$0	$0
	2	$440	$35	$13	$0	$0	$0
	3	$510	$71	$38	$13	$0	$0
	4	$620	$142	$75	$40	$0	$0
	5	$700	$201	$125	$67	$14	$0

These values are low and result in small or nil taxation obligations, if the ESS taxation point is at grant of the options – see table below based on a marginal tax rate of 34.5%.

Income Tax Tax Payable on ESS Taxation Value of Tranche							
10,000			Marginal Tax Rate	34.5%			
Term	1	$100	$5	$0	$0	$0	$0
	2	$152	$12	$4	$0	$0	$0
	3	$176	$24	$13	$5	$0	$0
	4	$214	$49	$26	$14	$0	$0
	5	$242	$69	$43	$23	$5	$0

It should be noted that the Regulations do not apply to Share Appreciation Rights (SARs) because their Exercise Price is notional, and only apply to options where the Exercise Price must be paid.

Threshold Share Price Growth for Options to Deliver Value to Employees

The following table indicates the various Compound Annual Growth Rates (CAGRs) required for the options to start to deliver value to employees. It clearly illustrates that the use of PEPOs with an initial ESS taxable value of nil (unshaded cells) is only suitable, when the CAGR in Share Price (initially $1.00) is likely to be more than 9.4% for PEPOs with a 4-year Term i.e. higher than typical ASX Share Price growth rates.

Compound Annual Growth Rate to Achieve Exercise Price in the Term							
		Exercise Price					
		$1.00	$1.18	$1.25	$1.34	$1.43	$1.70
Term	1		18.0%	25.0%	34.0%	43.0%	70.0%
	2		8.6%	11.8%	15.8%	19.6%	30.4%
	3		5.7%	7.7%	10.2%	12.7%	19.3%
	4		4.2%	5.7%	7.6%	9.4%	14.2%
	5		3.4%	4.6%	6.0%	7.4%	11.2%

Terms and Conditions of Options

This Insight is focussing on grants of options to employees generally, and not on grants intended to form the variable component of executive total remuneration packages where service and/or performance vesting conditions would be appropriate. For general employees it would generally not be appropriate to attach service or performance vesting conditions to the options.

Options contain an inbuilt performance condition in that no benefit arises from options unless the Share Price grows to above the Exercise Price (note: this is generally not accepted as a performance hurdle for executives, particularly inside the ASX 300). Further, the amount of benefit in an option grows as the Share Price grows. If the Exercise Price is set at a premium to the Share Price, then two implications arise. Firstly, a higher bar is set for Share Price growth before employees commence to share in the benefit of the Share Price growth. Secondly, shareholders receive a return via Share Price growth on their investment before they share additional returns with employees.

Taxation Considerations

Nil Taxable Value

As will be seen from the foregoing tables, there are some combinations of Terms and Exercise Prices that give rise to a nil taxation value. GRG's view is that when a nil taxable value arises at grant, there is no ESS tax payable at the grant and any future gains are assessed under the Capital Gains Tax (CGT) provision of the Income Tax Assessment Act 1997 (ITAA). The main reason not to hold shares following exercise is to settle the tax liability when tax is deferred, but in the case of up-front taxation this issue is resolved. On this basis using PEPOs with a nil taxation value can be attractive for employees for the following reasons:

1. No tax is payable until the shares or options are sold, which means that the employee will not need funds to cover the up-front grant and will have funds to cover the tax liability at disposal of the underlying shares (proceeds of sale).
2. If the shares have been held for 12 months (excludes period options were held) before sale or the options have been held for 12 months before they are sold, then the 50% CGT concession may apply. Of course, if shares are sold then the employee will need to fund the Exercise Price between the date of exercise of the options and the date of sale of the shares.

Some Taxable Value

No Tax Deferral and Not Tax Exempt

If the tax deferral and tax exemption provisions do not apply, then tax will be payable on the taxation value of the options in the year they are granted. Unless the grants become large, the tax liability should be modest and not cause any concern to employees. The amount of tax paid may represent a loss however, if the options do not ultimately produce value. No further tax is payable until the share or options are sold, and then any gain or loss is treated as capital gain. If the shares have been held for 12 months (excludes the period that options were held) before sale or the options have been held for 12 months before they are sold, then the 50% CGT concession may apply. The employee will need to fund the Exercise Price between the date of exercise of the options and the date of sale of the shares.

A tax deduction is not available for the accounting expense, but via the use of an employee share trust, a tax deduction can be generated at the time the options are exercised.

Tax Deferred

Tax deferral will apply to options if the tax exemption provisions do not apply, and the scheme under which the option is offered restricts the employee from immediately disposing of the options and states that Subdivision 83AC of the ITAA applies to the options. Tax deferral can also apply to options if there is a real risk of forfeiture (service or performance conditions for example), but such risk has been assumed to not apply because this Insight is about grants to employees generally.

If tax deferral applies, then the ESS taxing point will be deferred until the options are exercised. At that time 100% of any benefit/gain will be taxed as income under the ESS taxing provisions. If shares are sold within 30 days of exercise of the options, then the taxing point is deferred until the sale and then any gain is taxed under the ESS taxing provisions. If shares are held for more than 30 days, then any additional gain or loss will be treated under the CGT provisions.

A tax deduction is not available for the accounting expense, but via the use of an employee share trust, a tax deduction can be generated at the time the options are exercised.

Tax Exempt

If the options are granted under a plan that qualifies for the up to $1,000 per employee per annum tax exemption, then no tax will be payable at the time of grant, irrespective of the accounting or taxation valuations. Any gain made on subsequent sale will be taxed under the CGT provisions, but the taxation value at grant will be the cost based for calculating any capital gain i.e., the grant taxation value remains tax-free.

Of course, to qualify for the tax exemption the plan needs to comply with various taxation requirements including non-disposal until the earlier to occur of; termination of employment or the elapse of 3 years from the date of grant.

A tax deduction is not available for the accounting expense, however, the taxation value of options granted under a tax-exempt plan qualifies as a tax deduction for the company in the year of the grant.

It should be noted that using the taxation valuation method in the Regulations allows relatively large numbers of options to be granted within a tax-exempt plan $1,000 limit.

Conclusion

PEPOs represent an equity remuneration alternative for employees generally that is worthy of consideration, particularly by companies that have realistic expectations of high Share Price growth. They can be provided with a low accounting expense and optimal tax outcomes for employees. It should also be noted that a specialised plan is likely to be required, as certain statements that are typically included in Plan Rules may result in tax deferral until exercise, rather than up-front taxation. Such structures are not suitable for retention, due to a lack of service tests.