



The Changing Landscape of Equity Plans

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BACKGROUND AND INTRODUCTION

In the May 2009 budget, the Federal Government announced a number of changes to the taxation treatment of employee share schemes. While there have been some shifts in the stated policy position since that time, the government has largely retained their starting principle of up-front taxation. The changes have resulted in many employee share schemes being frozen as companies assess the impact of these changes on their employees.

Mastertek's expertise in this area is in the design of reward programs (including long-term incentives) that drive and support the organisation's strategic objectives. We do not provide tax advice and concentrate instead on developing underlying plan design principles that ensure, first and foremost, that the plans drive desired behaviour and align to the business strategy. Effective tax structures are then developed in conjunction with our partner organisations who provide formal legal opinion based on our proposed plan designs.

Information about tax included in this paper is intended to provide a general guide, the purpose of the paper being to assist our clients in obtaining a broad understanding of the potential impact of these and other changes on their employee share option plan. The paper in no way constitutes legal, tax or financial advice and we strongly recommend that our clients obtain specific advice on those matters as required.

DESIGNING EXECUTIVE LONG TERM INCENTIVE PLANS

Most executive long term incentive plans in Australia have preset performance hurdles in place that seek to align executive rewards with shareholder interests. This practice aligns with APRA's governance standards which require the design of long term incentive arrangements to take account of the risks in business activities while allowing time for the outcomes of these business activities to be measured reliably¹.

The Australian Shareholder's Association (ASA) policy statement² encourages companies to reward superior rather than satisfactory performance and indicates a strong preference for long-term equity incentives rather than short-term incentives. In particular, the ASA has suggested a vesting period of no less than four years and, specifically for CEOs, a holding lock of two years post vesting irrespective of cessation of employment.

Continuing performance testing of unvested equity incentives beyond cessation of employment is contrary to the current and proposed tax arrangements for employee share schemes which, if tax has not been paid up-front, continue to treat the cessation of employment as a tax event, regardless of any forfeiture or disposal restrictions that may continue to apply.

¹ APRA (May 2009); Prudential Practice Guide PPG 511 – Remuneration, page 35.

² Australian Shareholders' Association, (March 2009); Policy Statement on Executive Remuneration



Mastertek believe that the changes announced by the Treasury in relation to the tax treatment of employee share schemes, together with the work of APRA and the Productivity Commission happening in parallel, will have the effect of increased scrutiny on long term incentive plan design and the selection of performance measures that drive superior performance.

OUR VIEW OF THE POTENTIAL IMPACT

Whilst the legislative changes have become clouded, to say the least, amongst the fall-out and swell of public opinion resulting from the original and misguided positions set out in the Federal Budget announcements earlier in the year, the outcome is likely to be a much more straightforward tax environment. The new rules remove the option for individuals to determine whether or not they will defer tax or pay it up front. Instead, equity plan design itself will determine when tax events occur, be it on grant or at some point thereafter.

We believe that the impact of the changes will likely deliver the intended outcomes of the government (being to realise a more accurate collection of tax relating to equity plans) and at the same time enable organisations to return to focussing on the underlying plan design principles and whether or not the plans will drive desired behaviour and thus organisational performance with the tax implications being that much clearer for all.

ACTIONS TO CONSIDER

When considering the potential impact of the changes on your long term incentive plans, some initial questions that organisations might consider include;

- Are our Award Shares Ordinary Shares?
- Are the interests provided under the plan considered to be shares or rights?
- Is there a real risk of forfeiture in our plans?
- If the plan is deemed to meet the requirements for deferral set out in this document, when would the likely tax events occur?

Should your plans for any reason be deemed not to have met the criteria required for tax deferral (set out in detail later in this paper), up-front taxation can have a significant and adverse cash flow impact on participants, as they will be required to pay tax in the income tax year of the grant. In this circumstance, we recommend that our clients consider their long-term incentive arrangements in the context of the overall reward strategy, and if appropriate, consider the timing of any short-term incentive payments to assist participants in funding their tax liability or offering some form of loan arrangement to key employees.



Regardless of the implications for tax deferral, we recommend all our clients consider the following brief list of activities that might be undertaken to ensure plans are current, and that both the company and the participants interests are protected;

1. Revisit the formal and legal documentation associated with the plan to ensure that tax guidelines contained therein are consistent with new legislation.
2. Ensure that any grant prior to 1 July 2009 is appropriately recorded and agreements appropriately formalised.
3. Communicate with those employees that have existing equity grants in place the impact the proposed legislative changes may have; even if the impact is NIL.
4. Ensure that any future grants have appropriate performance criteria ensuring a real risk of forfeiture.

Put in place processes to comply with the annual reporting requirement.

OUR CONSULTANTS

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UNDERSTANDING THE PROPOSED TAX REGIME FOR EMPLOYEE SHARE SCHEMES (ESS)

The manner of taxation on discounts delivered through employee share schemes in the year options or rights are acquired is the underlying principle of the changes proposed by the Federal government.

Extracts from the Exposure Draft³ issued by the Treasury are summarised below:

Date of effect

- The changes apply to shares, rights and stapled securities acquired on and after 1 July 2009. Note that although shares, rights and stapled securities acquired before 1 July 2009 will also be brought within the new rules, transitional arrangements will ensure the effect of the existing law is maintained for these securities.

Market Value

- The Board of Taxation will consider how best to determine the market value of benefits arising from an employee share scheme. The draft regulations⁴ essentially preserve the existing rules (contained within Division 13A of the tax regulations) as they relate to valuing unlisted rights. The value of an unlisted right is, at the choice of the taxpayer, either:
 - a) the market value of the right, or
 - b) the amount calculated using tables set out in the regulations.

Up-front taxation

- Generally, any discount to the market value of ESS interests in shares or rights provided under an employee share scheme will be taxed upfront (that is, in the income tax year that the shares or rights are acquired). This means that the market value of the discount must be included in an employee's assessable income for that income year.
- A \$1,000 tax exemption is available to taxpayers participating in an employee share scheme who pay tax upfront, if they have a taxable income (after adjustments) of \$180,000 or less, and the employee and the scheme meets certain conditions, including:
 - the participant must be employed by the company or a subsidiary of the company;
 - all the ESS interests available for acquisition under the scheme must relate to ordinary shares;
 - the scheme must be offered to at least 75 per cent of permanent employees;
 - the shares or rights provided must not be at real risk of forfeiture;

³ The Parliament of the Commonwealth of Australia (2009); Exposure Draft: Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, page 3

⁴ Draft Income Tax Assessment Amendment Regulations 2009



- the shares or rights must be required to be held by the employee for three years or until the employee ceases employment; and
- the employee must not receive more than five per cent ownership of the company, or control more than five per cent of the voting rights in the company, as a result participating in the scheme.
- Employees can no longer choose whether to pay tax up-front or to defer tax; it now depends on the structure of the scheme rather than an election of the employee.

Deferral of tax

- Deferral of tax is available for two types of employee share schemes – those where the ESS interests are at real risk of forfeiture, and those where the ESS interests are acquired under certain salary sacrifice arrangements (including the requirement that the employee must receive no more than \$5,000 worth of shares under those arrangements in a single income tax year).
- Under a deferred tax *share* scheme, tax becomes payable in the earliest income tax year that:
 - there is no longer a real risk that the employee will lose the share under the conditions of the scheme other than by disposing of it and there are no further restrictions preventing disposal; or
 - the employee ceases the employment in respect of which they acquired the share or right; or
 - 7 years after the employee acquired the share or right.
- The deferred taxing point for *rights* plans (such as Matrix's employee share options plan) is in the earliest income tax year that:
 - there is no longer a real risk that the employee will lose the right under the conditions of the scheme other than by disposing of it, exercising it or letting it lapse without exercising it **AND** there are no further restrictions preventing the employee from exercising or disposing of the right; or
 - the employee ceases the employment in respect of which they acquired the share or right; or
 - 7 years after the employee acquired the share or right.
- Plans that are subject to a real risk of forfeiture rule will only be eligible for tax deferral if they meet the following additional qualifying criteria:
 - The ESS interest must be acquired at a discount under an employee share scheme;
 - The participant must be an employee of the company or an employee of a subsidiary of the company;
 - All of the ESS interests available for acquisition under the scheme must relate to ordinary shares;



- The employee must not receive more than five per cent ownership of the company, or control more than five per cent of the voting rights in the company, as a result participating in the scheme;
- In respect of shares, the employer must offer a scheme or schemes that are available to at least 75 per cent of the permanent employees of the company. This means over all the schemes that the employer offers, more than 75% of permanent employees must be able to access shares under at least one of those schemes. (Note that this non-discriminatory rule is not a requirement for tax deferral where the ESS interests represent a right to acquire a share.⁵)
- ‘Real risk of forfeiture’ means a reasonable person would consider that there is a real risk that the employee would lose the interest, or never receive it, other than by disposing of it, exercising it, letting it lapse, or through the market value of the ESS interest falling to nil.
- For each participating employee, the employer will need to make an assessment of whether there is a real risk of forfeiture with respect to that employee. The ‘real risk’ needs to be more than a possibility, but does not need to be significant.

Examples of a real risk of forfeiture might include:

- Minimum term of employment, with forfeiture on cessation of employment; or
- Meaningful performance hurdles.

Examples of situations that are **not** considered to be a real risk of forfeiture might include:

- Restrictions from disposing of a share or right for a period of time; or
- Contrived schemes, where the risk is highly unlikely to arise;
- Forfeiture due to fraud or gross misconduct.
- In the case of rights (such as share options), an employee who chooses not to exercise the right is still liable for tax in the income year that the forfeiture provisions are lifted.

⁵ Legal advice provided by Babingtons Law (www.babingtonslaw.com) in relation to this matter is as follows: “Section 83A-105(1)(c) essentially says that if the ESS interest is a share (as distinct from an Option) then the 75% non discriminatory test applies (subsection 83A-105(2)). Whereas 83A-105(1)(d) says that if the ESS interest is a right to acquire a share (i.e. an option) then only real risk of forfeiture applies (Subsection 83A-105(3)). In short the new law will be the same as the current law under Div 13A which states that the 75 non discriminatory test only applies to the grant of shares, not options.”



New Reporting Requirement

- An annual reporting requirement is to be introduced for employers to report to the Commissioner and to participating employees.
- The reports are to be provided in an approved form (which has not been determined), but may include:
 - the employer's ABN; or
 - the employee's name and address;
 - the employee's TFN (if it has been provided to the employer);
 - the employee's ABN (if it has been provided to the employer);
 - the following information about any ESS interests which have been provided during the income year and will be taxed upfront:
 - the number of the interests;
 - the amount paid, at or before the time of acquisition, towards acquiring the interests;
 - the employer's estimate of the market value of the interests at the time of acquisition;
 - the amount of withholding tax (if any) paid in respect of the interests during the year;
 - the following information about any interests which have been provided during the income year and on which tax will be deferred:
 - the number of the interests;
 - the amount paid, at or before the time of acquisition, towards acquiring the interests;
 - the following information about any interests that the employer has provided to an employee during the year or during a previous year, on which tax was deferred, and the ESS deferred taxing point for those interests occurred during the year.
 - the number of the interests;
 - the amount paid, after the time of acquisition but not after the ESS deferred taxing point, towards acquiring the interests;
 - the provider's estimate of the market value of the interests at the ESS deferred taxing point;
 - the amount of withholding tax if any the provider paid in respect of the interests during the year.

ADDITIONAL INFORMATION

Draft guidelines issued by Treasury:

<http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1594>

APRA's proposed extensions to governance requirements and Prudential Practice Guide:

<http://www.apra.gov.au/Policy/Response-to-submissions-Remuneration-Proposed-extensions-to-governance-requirements-for-APRA-regulated-institutions.cfm>

Productivity Commission review of executive remuneration:

<http://www.pc.gov.au/projects/inquiry/executive-remuneration>