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Employee shares in volatile markets

- by Gary Fitton, Director, Remuneration Strategies Group

A recent report in the *Australian Financial Review* (p 4, 16 January 2009) quoted a recent survey of employee share option plans, which concluded that almost 75% of options issued by the top 50 ASX companies surveyed since 2003 are now worthless, as they are 'out of the money' and 'under water' (ie the current share price is less than the exercise price of the option). The study also showed that, of the bottom 2/3rds of the companies listed in the S&P/ASX 300 Index, almost 90% of options issued since 2003 were also out of the money and worthless.

Similar surveys from overseas are displaying similar results, but are also demonstrating that options issued in 2007 and 2008, with exercise prices set at the peak of the boom share market run, will have an even greater likelihood of being 'out of the money'.

Remuneration options

Over the past 2 decades, there has been a worldwide trend for companies to top-up employees' base or fixed remuneration by issuing shares or options under an employee share plan (ESP).

Recent studies have shown that businesses, especially capital intensive companies in their initial capital growth phase, can maximise their total business capital investment by maximising their use of share options for the remuneration of their labour inputs (see Babenko, Ilona, Lemmon, Michael L and Tserlukevich, Yuri, " *Employee Stock Options, Financing Constraints, and Real Investment: Theory and Evidence*", University of British Columbia, UBC Winter Finance Conference 2008 - Available on [Social Science Research Network Website](#)).

In contrast to paying cash salary, paying staff with share options requires no immediate cash outflow for the company issuing the options and generates cash inflow at the time the options are exercised.

US-based studies of S&P 500 and NASDAQ 100 firms from 1999 to 2004 have demonstrated that, on average, outstanding (ie unexercised) employee option allocations from US corporations are equivalent to 12.5% of their total issued capital (see Babenko, etc paper referred to above). Those studies also indicate that the annual proceeds from the exercise of options and associated tax benefits are equivalent to 1.3% of US firms' total assets.

Given the average levels of net capital investment and R&D for those companies, the capital cash inflows associated with allocations and exercise of options constitute around 25% of their total investment expenditure.

Consequently, one must conclude that companies' maximisation of capital investment expenditure is positively correlated to the allocation and exercise of employee options.

This impact is strongest in R&D companies and those firms that can be classified as financially constrained by requiring a high degree of capital intensive investment for the conduct of their business programs.

This impact is exacerbated by the current worldwide recessed business conditions with the concomitant reduction of cash flows. Assuming such conditions to be transient (albeit severe) and part of the general economic business cycle, there will be a bottoming and reversal into the classical upturned 'J' curve of improved business conditions.

The expensing of employee equity

The changes in accounting standards, stock exchange listing rules and corporations law now mean that employees' total remuneration and equity-based benefits are properly valued, communicated to participants, disclosed to 'stakeholders' and expensed in the annual profit and loss accounts of companies.

In particular, the introduction of accounting standard AASB2 for share based payments, with its antecedents in the US based Generally Accepted Accounting Principles (GAAP) and UK based International Accounting Standards Board (IASB), has created a sound basis of integrated and coherent valuation principles for a range of employee and executive equity delivery methodologies.

It should go without saying, that any employee and executive remuneration arrangements should not only be optimal, for the employees and executives concerned, but for the company, its shareholders and other stakeholders.

Increased demand for expertise

The trend to integrate employee equity into the incentive-based remuneration strategies of companies, combined with the new legislative, regulatory and financial reporting obligations, has caused a dramatic increase in the demand for expertise in the market for employee share plan administration and related consulting services.

What is an Employee Share Option?

An option is a contractual right to purchase a share (ie a call option) or sell a share (ie a put option) at a stated exercise price. Employee share options are usually call options, with an exercise price, typically, set at the market value of the subject shares at the date of issue of the options.

However, options can have the exercise price set at a discount or a premium to the market price prevailing at the time of issue of the options.

Employee share options usually have a life of 5 years and are often subject to a vesting period (usually 3 years) and performance hurdles (usually linked to Total Shareholder Return [TSR]), but may be related to more internally based cost savings or productivity measures, given the current generally recessed market share price conditions). These recessed market conditions are also conducive to some companies discounting option exercise pricing, to bolster their effectiveness in bear market conditions.

Employee share options are usually not transferable and cannot be traded by the employees.

Importantly, for companies wishing to divert their cash resources to capital project investment unlike cash salary, there is no net cash outflow at the time of the grant of the options.

Also importantly, like paying salary, provided an interposed entity is introduced to acquire and deliver the share options to the employees, the company may obtain an income tax deduction for irretrievable contributions made to that entity (eg a plan trustee) to provide those options to the employees (refer ATO Interpretative Decision ATO ID 2002/1074).

The options are usually issued at a value determined under a Black Scholes Merton valuation in line with accounting standard AASB 2.

The contributions utilised to acquire the options for consideration would only become assessable to the issuing company if, and when, the options were cancelled, released or abandoned (refer s 104-30 of the ITAA 1997).

As companies are precluded from accessing the 50% exemption on discount capital gains afforded under Div 115 of the ITAA 1997, those contributions would become taxable income of the company and subject to the prevailing corporate tax rate of 30%.

Cashless exercise

Typically, most options provided to employees have been issued with an exercise price at the prevailing market price of the shares, to produce a 'growth only' benefit, which is realised by the exercise of the options, acquisition of the shares and the immediate sale of the shares, with the profit being made up after deducting the payment of the exercise price.

This realisation of profit has often been achieved by the so-called 'cashless exercise' of options. Under this "cashless" process, the employees exercise their vested options by instructing their broker to sell their shares at the prevailing market price, the broker repatriates the exercise price back to the company that issued the options, and the employee realises in cash the net benefit of the growth in the shares over the holding period of the options.

Special incentive measures

The generally depressed share prices and earnings that we are experiencing at the moment can disrupt companies' incentive-based equity plans, and many firms are considering special measures to maintain the effectiveness of their incentive measures to retain key employees and boost morale.

In contrast to previous share market downturns, a greater percentage of long-term equity based incentives have been linked to fixed base TSR return contingency eg ranging from 9-15% over a 3-year vesting period. These fixed TSR returns may be quite achievable in ordinary market conditions, but unrealistic in the current generally depressed market.

Some companies are considering new performance hurdle measures based on net debt targets, pre-tax profitability and TSR matched to a selection of comparable companies (ie rather than a fixed base TSR contingency).

Companies are intending to offer full value equity as zero exercise priced options (Zepo), performance rights or restricted shares.

Some companies are proposing to replace 'out of the money options' with options at current lower market-based exercise prices. This will also have the effect of reversing the previous higher expensing values for the 'underwater' options and replacing them with the lower expensing values for options with the currently reduced option exercise price, to give their options more 'bite' as a long-term incentive.

However, there has been a recent trend for companies to make regular annual allocations of options that will automatically replace the 'out of the money' options by the ongoing issue of fresh options, with exercise prices at the lower share values. Those options that are underwater at the time of exercise will usually lapse unexercised as a part of the natural attrition of ineffective option allocations inherent in the regular allocation of options.

Employee share trusts

Some companies with employee share trust (EST) arrangements are taking the opportunity to acquire substantial amounts of cut-priced shares to be placed in an unallocated share account, to be reallocated to employees if or when the share prices recover. For those employees fortunate enough to be able to switch their allocated assets from the depressed employer share values into more secure, fixed interest investments, some employers and share plan trustees are facilitating such switching, to ensure employees' investments in the EST's are protected against further declines in employer share values.

Typical employee share option scenario

Option valuation

The options proposed to be offered to employees would need to be valued and expensed under the relevant accounting standard, being AASB 2, under a Black Scholes Merton methodology.

Growth-only options

Utilising the RSG Equity-based Remuneration calculator, each growth-only or geared option would be valued at 75 cents.

This valuation is based on the following assumptions:

- a share price of \$4.00;
- a "strike" or exercise price of \$4.00;
- a call life of 5 years;
- a vesting period of 3 years;
- a risk-free interest rate for the company of 3.25%;
- a lost dividend yield of 5.5%;
- a volatility factor of 30%; and
- staff turnover of 5%.

For the gross remuneration cost of \$200,000, the employee would receive 266,666 options.

Growth in share value

As the options have been issued with an exercise price at the prevailing market value of the shares, the only basis for providing a benefit under this arrangement is from the growth in the share value, over the period the options are held unexercised by the employee. This is referred to in colloquial, general business parlance, as a 'growth-only' benefit.

Zepo

We have also valued zero exercise priced options (Zepos), as an alternative to be considered in contrast to the growth-only options.

The value of the Zepos, utilising the RSG Equity-based Remuneration calculator, will be \$3.41 per option.

This valuation utilises the same assumptions as the growth-only options, except, of course, the 'strike' or exercise price will be zero.

Practical example

Based on recent cost/benefit analyses of alternatives for various option-based delivery methodologies for employee long-term incentives and employee retention mechanisms, we prepared a comparative summary of the cost/benefit attributes of a range of those alternative equity based, long-term incentive (LTI) delivery facilities.

We will assume these comparisons have been prepared for a Large Mining Company (LMC).

Assumptions

- The employee receives a relatively low fixed remuneration and is 'topped up' with substantial share option-based incentives;
- the employee has a marginal income tax rate of 46.5%;
- the amount of the long-term incentive (LTI) is \$200,000;
- options are issued for nil consideration;
- exercise price is at the prevailing market price of the share (eg \$4);
- vesting period of 3 years;
- share value of \$10 at the end of year 3 (refer **Table 1**);
- we have also provided examples of share values of \$4, \$2 and \$1 respectively at the end of year 3 (refer **Tables 2 and 3**);
- LMC AASB2 option value of 75 cents, expensed over the 3-year vesting period;
- LMC AASB2 Zepo option value of \$3.41, expensed over the 3-year vesting period; and
- we assume the share is sold as a consequence of option exercise, but this would only need to occur in Examples 1, 2 and 3.

Three examples are set out below.

Option Example 1: Growth-only option with s 139E election

The s 139E election to be taxed upfront will have a taxable value of 11.6% of the \$4 market value of the share (refer s 139FK-FM of the ITAA 1936), being 46.4 cents per option.

The employee will pay 21.6 cents per option income tax (ie assuming a 46.5% income tax rate), and will establish a CGT cost base of 46.4 cents per option.

When the employee exercises the option and sells the \$10 share to pay the \$4 exercise price, the employee will:

- have paid income tax upfront of 21.6 cents on the option acquisition;
- pay CGT of \$1.29 (ie $\$10 - \$4.46 = \$5.54 \times .5 \times .465 = \1.29); and
- receive net after-tax proceeds of \$4.50 (ie $\$10 - \$4 = \$6 - [\$0.216 + \$1.29] = \4.50).

The employee will receive 266,666 options (ie \$200,000 divided by 75 cents).

Upon exercise of the options, the company will receive an amount of \$1,066,667 as an accretion to issued capital. It will also have received a tax saving of \$60,000 in respect of the tax deductible contributions to the Plan Trustee.

The AASB2 value of 75 cents per option will be debited to the employee's gross remuneration package as a long-term incentive/retention benefit.

The employer will expense the AASB2 value of 75 cents over the 3-year vesting period (ie at 25 cents per year).

The employer will receive an income tax deduction under s 8-1 of the ITAA 1997 for contributions to the plan trustee (ie equal to the 75 cents AASB2 value of the options) upfront in the year they are incurred (refer ATO Interpretative Decision ATO ID 2002/1074).

We have assumed that the share is sold upon the exercise of the option, because the employee will need to sell the shares to pay the exercise price, in the so-called 'cashless exercise' process that has typified most Australian employee option plans over past decades.

This process undermines the potential for the equity of LCM to act as a sustainable incentive, as it acts to dissipate the equity held by employees. It turns the employee share plan into a short-term speculative exercise, rather than an ongoing and long-term investment and goal alignment strategy.

The other concern with this arrangement is that, if the share price remained at \$4 or dropped to \$2 or \$1, the employee would derive no long-term incentive benefit under the plan (see **Tables 2 and 3**).

Another problem with this alternative is encouraging the employees to make the s 139E election and pay the tax upfront on an option they cannot dispose of for 3 years.

In this case, the upfront income tax would amount to \$57,536, which, if the options were underwater, the employees could only retrieve (ie with interest) from the ATO upon cancellation of the options or at the end of the 5-year option life. Short of mortgaging the family home, most employees (including so-called 'fat cat' executives) simply do not have ready access to that amount of money.

Our experience is that, as a rule, the s 139E election does not happen and can detract from the general appeal and effectiveness of the plan for employees. Consequently, employees do not retain their shares, as they need to sell the shares to pay the exercise price and the tax on exercise (see Option Example 2 below).

Option Example 2: Growth only option with no s 139E election

As is typical in these arrangements, the employee will not make a s 139E election to be taxed upfront.

Assuming the option to be qualifying rights under the provisions of s 139CD of the ITAA 1936, the employee will exercise at year 3, with the following consequences,

- sell the shares for \$10 each and pay the exercise price of \$4 each, resulting in an income taxable discount of \$6 per share;
- pay income tax of \$2.79 (ie $\$10 - \$4 = \$6 \times 46.5 = \2.79); and
- receive net after-tax proceeds of \$3.21 (ie $\$6 - \$2.79 = \$3.21$).

The employee will receive 266,666 options (ie \$200,000 divided by 75 cents).

Upon exercise of the options, the company will receive an amount of \$1,066,667 as an accretion to issued capital. It will have received a tax saving of \$60,000 in respect of contributions to the Plan Trustee.

The AASB2 value of 75 cents per option will be debited to the employee's gross remuneration package as a long-term incentive/retention benefit.

The employer will expense the AASB2 value of 75 cents over the 3-year vesting period (ie at 25 cents per year).

The employer will receive an income tax deduction under s 8-1 of the ITAA 1997 for contributions to the plan trustee (ie equal to the 75 cents AASB2 value of the option) upfront in the year they are incurred (refer ATO ID 2002/1074).

While there is no upfront tax for the employee to pay, for the reasons already stated above in the Option Example 1, we believe this alternative to be sub-optimal as the shares must be disposed of to pay the exercise price and the income tax. This dissipates the equity in the employee share plan and, therefore, is an inefficient application of employer shares.

Again, as in Option Example 2 above, the other concern is that, if the share price remained at \$4 or dropped to \$2 or \$1, the employee would derive no long-term incentive benefit under the plan (see **Tables 2 and 3**).

Option Example 3: Zero exercise price option (Zepo)

This example is of a Zero Exercise Price Option (Zepo), provided as a long-term incentive. It can also be structured as, so-called, performance rights or restricted shares.

The AASB2 option value of \$3.41 will be expensed in the accounts of LMC over a 3-year vesting period. This is based on a share value of \$4, discounted by the cost of options not being capable of paying dividends.

We have assumed the employee will not make a s 139E election, as the taxable discount for s 139FC purposes will be the full market value of the share (ie \$4). Consequently, had the employee elected to pay tax on the acquisition of the options, he or she will be liable for income tax upfront of \$1.86 per option and will have a CGT cost base of \$4 per option. As the employee is being offered 58,651 options (ie 200,000 divided by \$3.41), he or she would be liable for a total of \$125,513 income tax on the acquisition of the options.

Interestingly, Zepo-based option valuation is one of the few occasions that the Div 13A valuation for tax purposes will be greater than the accounting valuation for AASB2 purposes. This is due to the fact that the Div 13A valuation does not factor in the cost of the options not being able to pay dividends. To that extent, the Div 13A valuation actually overstates the value of the option for taxation purposes at acquisition.

The employer will make a tax deductible contribution of \$3.41 to the plan trustee to acquire an option as a fresh issue.

The trustee will have acquired the option for its market value of \$3.41 and allocate the option to the employee.

The AASB2 option value of \$3.41 per option will be debited to employee's gross remuneration package as a long-term incentive/retention benefit.

The employee will acquire the options with the following consequences:

- no dividends are payable until the options are exercised into shares. The trustee will distribute any dividends;
- the employee exercises the option and receives \$10 per option as an income taxable benefit;
- the employee will receive net after-tax proceeds from exercise and sale of the shares of \$5.35 per option (ie $\$10 - \$4.65 = \$5.35$).

The employer receives a tax deduction for the contribution of \$3.41 per option, resulting in a net tax saving of \$60,000.

Upon exercise of the options, the company will receive no further amount as accretions to issued capital.

As there is no exercise price to pay, the employee will not need to sell the shares to pay the exercise price, but will need to sell the shares to pay the income tax.

For LMC, this means that the equity in the employee share plan is dissipated and has no incentive and goal alignment attributes over the long term.

Conclusion

Where the shares grow in value to \$10, Options 1 and 2 are clearly the optimal equity delivery arrangement (refer **Table 1**). However, where the shares do not grow in value, Option 3 is clearly the optimal equity delivery arrangement (refer **Table 2**). However, these equity delivery arrangements should not be viewed as mutually exclusive.

Depending upon the purpose of each proposed allocation of Share Units, the employer may choose to utilise growth-only options or Zepos under the EST arrangement.

The benefit of Zepos, or full-value shares, is that they produce a return to the participating employees even in 'bear' or 'no-growth' market conditions (refer **Table 3**).

The benefit of growth-only options or loan-based shares (ie with the exercise price or loan at the market value of the share at the time of issue of the Share Unit) is that it maximises employee

returns in 'bull' or 'high-growth' market conditions. However, they produce no return to the employee in 'bear' or 'no-growth' market conditions.

Recently, one insightful listed company proposed to break the LTI into its component parts, being:

- the retention component of the LTI; and
- the pure incentive component of the LTI.

It then based the retention component of the LTI as a 'full-value' ZEPO and the pure incentive component of the LTI as a 'growth-only' classical option plan.

This means that the employees would receive:

- their retention benefit, even if no growth in share value occurred; and
- their incentive component, which would maximise their incentive component in a 'bull market' or 'high-growth share value growth scenario',

provided they remained with LMC for their requisite service period - which in this case was a period of 3 years.

This combination of full-value and growth-only equity approaches means that employees are encouraged to remain with the company and perform to maximise the growth and profitability potential of LMC, their employing company.

The common underlying deficiency in these 3 alternative option strategies is that none of them facilitate the retention of shares by the participants after exercise, thereby dissipating the employee equity into a short-term cash realisation exercise.

Table 1

Table 1			
	OPTION 1 s 139E Election	OPTION 2 No s 139E Election	OPTION 3 Zepo
Assumptions			
AASB2 valuation	\$0.75	\$0.75	\$3.41
\$ amount LTI	\$200,000	\$200,000	\$200,000
No of units	266,666	266,666	58,651
Exercise price	\$4.00	\$4.00	\$0.00
Market price at sale	\$10.00	\$10.00	\$10.00
Company	\$	\$	\$
Net cash flow	\$0	\$0	\$0
Tax deduction	\$60,000	\$60,000	\$60,000
Receives from exercise	\$1,066,667	\$1,066,667	\$0
Net cash inflow	\$1,066,667	\$1,066,667	-
P&L AASB2 - Expensing PA over 3yrs	\$66,667	\$66,667	\$66,667
Employee			
Receives \$ per share	\$4.50	\$3.21	\$5.35
Pays tax to upfront	\$57,536	-	-
Receives from exercise	\$1,199,997	\$855,998	\$313,783

Table 2

Table 2: Comparative Market Prices at Exercise and Sale			
	OPTION 1 s 139E Election	OPTION 2 No s 139E Election	OPTION 3 Zepo
Market price at sale			
\$10			
Company net cash inflow	\$1,066,667	\$1,066,667	\$0
Employee receives	\$1,199,997	\$855,998	\$313,783
\$4			
Company net cash inflow	\$0	\$0	\$0
Employee receives	\$0	\$0	\$125,513
\$2			
Company net cash inflow	\$0	\$0	\$0
Employee receives	\$0	\$0	\$62,757
\$1			
Company net cash inflow	\$0	\$0	\$0
Employee receives	\$0	\$0	\$31,378

Table 3

Table 3: Tabulated Summary							
Example	Net return to employee				Dividends	Tax upfront	Shares retained in plan
	\$10 share price	\$4 share price	\$2 share price	\$1 share price			
1	\$4.50	0	0	0	No	No	No
2	\$3.21	0	0	0	No	Yes	No
3	\$5.35	\$2.14	\$1.07	\$0.535	Yes, after Option Exercise (5.5% yield)	No	No