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### **Employee shares in hard times**

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In the current "tough" economic circumstances, as strategic remuneration practitioners, we have noticed a trend for companies to opt out of employee share option-based remuneration and replace that equity with ongoing, fixed, salary entitlements.

That trend may not be in the best interests of the company, its shareholders and its employees, if the resulting drain on the company's cash resources retards its capacity to:

- contain cash cost outflows;
- survive the current general economic downturn; and
- prepare the business for the inevitable upturn in general economic conditions.

This article canvasses the benefits that companies, employees and shareholders can obtain by maintaining an appropriate level of employee share option remuneration.

#### **Remuneration options**

Over the past 2 decades, there has been a definite 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 the S&P 500 and the 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 which 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 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.

### **What is an employee share option?**

Typically, employee share plans provide employees with a right to purchase a share at a stated exercise price (usually the market value of the subject shares at the date of issue of the options).

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, but may be related to more internally based productivity measures, given the current generally recessed market share price conditions). These conditions are also conducive to some companies discounting option exercise pricing, to bolster their effectiveness in bear market conditions.

Employee 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 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 for 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%.

### **Taxation environment**

While there are certain confronting issues for unlisted companies, the taxation environment for the provision of substantial allocations of employee equity in stock market listed organisations is very conducive to the proliferation of such arrangements. That conducive taxation environment is demonstrated in the example set out below.

### **Typical employee option exercise example**

#### ***Initial public offer (IPO)***

Like most small companies making an IPO on a recognised Australian stock exchange, the shares will be offered at the minimum offer price allowed by the relevant listing rules, which is usually 20 cents.

#### ***Option valuation***

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

Utilising the RPC Equity-base Remuneration calculator, each option would be valued at 14.86 cents.

This valuation is based on the following assumptions:

- a share price of 20 cents;
- a "strike" or exercise price of 20 cents;
- a call life of 5 years;
- a vesting period of 3 years;
- a risk-free interest rate for the company of 7.50%;
- a lost dividend yield of 4%;
- a high volatility factor of 140%; and
- staff turnover of 5%.

For the gross remuneration cost of \$10,000, the employee would receive 67,295 options.

### ***Growth in share value***

As the options are often 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 usage, as a 'growth only' benefit.

### ***Section 139E election***

If the employee chose to make a s 139E ITAA 1936 election to be taxed upfront in the year of income he or she acquired the options, and be taxed on the tabulated tax market value in accordance with s 139FC, the employee would be subject to an income tax liability of \$365.40 - based on a s 139FM valuation percentage of 11.6% of the IPO price of 20 cents per share and assuming an income tax rate of 31.5% (including the 1.5% Medicare levy).

The employee would also establish a CGT cost base for the options of \$1,160, under the provisions of s 130-80(3) of the ITAA 1997. That cost base would be expanded by the payment of the exercise price of 20 cents per option, under the provisions of s 134-1.

### ***Exercise of options***

If the options were exercised into shares, the employee would need to provide payment for the exercise price.

This is usually achieved by the so-called practice of 'cashless' exercise of options. This 'cashless' exercise is achieved by the employee instructing the broker to sell the shares acquired from the exercise of the options immediately upon exercise, thereby providing the employee with the cash resources to cover the exercise price.

While this exercise may be 'cashless' for the employee, it is not cashless for the company, with the share market effectively providing the capital injection by way of the share sale proceeds effectively paying the exercise price.

The profit on sale (ie the difference between the proceeds of sale of the options and the exercise price) is then distributed as cash to the employee.

That profit will reflect the growth in the value of the shares over the period the options were held unexercised.

### ***Practical consequences***

If the share price grew to \$1.40 over the 3-year vesting period, the employee would:

- exercise the 67,295 share options;
- instruct the company's favoured stock broker to sell the shares and receive sale proceeds of \$94,213;
- apply part of the sale proceeds to pay the total exercise price of \$10,000;

- receive the \$84,213 as a taxable capital gain; and
- pay the discounted CGT of \$17,233 on the net taxable capital gain of 83,053 (ie assuming a tax rate of 41.5%, including the 1.5% Medicare levy) and subject to the 50% tax exemption available under s 115 of the ITAA 1997.

### ***Employee's net benefit***

This would result in a net, after-tax benefit to the employee of \$64,145.

Obviously, this is a very good result for the employee, who has agreed to receive a part of his or her total remuneration package valued at \$10,000 in the form of concessional tax options, instead of salary taxed at a rate of 31.5% and probably immediately consumed.

### ***Cost to the company***

#### **Salary**

The cost to the company of paying a salary of \$10,000 is that amount, less the tax saving of 30% (ie \$3,000) resulting in a net cost of \$7,000.

#### **Options**

The cost to the company of making an equivalent contribution to the plan trustee would also be \$10,000.

### ***Cash flow consequences***

#### **Salary**

The cash salary alternative will result in a net cash outflow of \$10,000, with the \$3,000 being recouped at a later date as a tax saving in terms of a lower corporate tax liability.

#### **Options**

Of course, the option plan trustee, in line with the stated purpose of the trust, would utilise the contribution moneys to purchase \$10,000 worth of freshly issued options to the plan trustee, which would result in no cash outflow from the company.

Those moneys would be credited to the equity capital amount of the company. In effect, the \$10,000 has been retained by the company and merely transferred as a debited expense in the profit and loss account, and credited to the company's capital account. The amount of \$10,000 would then be capital finance available for the company to invest in its business projects.

### **Accounting treatment**

If the options were subject to a 3-year vesting term, which has been the norm for most ASX listed corporate allocations of employee options, under the Australia Accounting Standards Board's AASB 2, the gross amount of the expense of \$10,000 would be spread and expensed in

the annual published accounts of the issuing company evenly over the 3-year vesting period at \$3,333 per annum.

### ***Cost to shareholders***

For shareholders in the company, the company has remunerated its employees by the provision of equity. That cost has been fully reflected in the company's accounts - so there are no hidden dilutory costs, which characterised many employee share option strategies in the pre-AASB 2 days (ie before 1 January 2005).

Upon exercise of those options, the company will obtain a capital injection from the market-sourced payments of the option exercise price. But, by utilising the share option-based remuneration strategy, the company has preserved its essential cash resources during the recessed economic conditions and rewarded employees by a share of the company's surplus values achieved during the upturned business conditions.

### **Conclusion**

The issue of options by companies experiencing significant growth outlooks to employees in lieu of cash salary is a far more effective method of remunerating their employees, especially those companies seeking to maximise their cash capital project investment.

Not only are moneys retained within the business, but the expense is immediately deductible to the company in the financial year it is incurred and then expensed in the published accounts and spread over the vesting period (ie in this case, 3 years).

Of course, this assumes that the business has been successful and achieved the anticipated growth in share value. It may have a higher risk profile for employees than purely salary-based remuneration. Employees may be excessively optimistic about their company's prospects - but they are usually more aware about the potential of those prospects and their own involvement in realising that potential than other less involved shareholders. It may not suit all employees, but it does suit an increasing number of employees - especially those in nascent industries with high growth potentials.

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