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When sharing is not caring

- by Gary Fitton, Director, Remuneration Strategies Group Pty Ltd

With the tabling of the Bill to amend the taxation of employee share plan benefits (ie the *Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009*), companies offering their employees share and option benefits need to review their current employee share and option plan arrangements to ensure that under these new taxing provisions, there are no unintended and unexpected taxation triggers which may arise.

If passed into law, these provisions will have retrospective application from 1 July 2009.

This article focuses on option arrangements, which are the most common form of employee equity arrangements in companies listed on Australian Stock Exchanges.

Some reviews of certain rather standard option-based share plans offered by large Australian listed companies, which were effective under the previous provisions of Div 13A of the ITAA 1936, have revealed some unsettling potential taxation consequences for their employees under the proposed provisions of the proposed new Div 83A of the ITAA 1997.

The provisions of Div 13A were significantly different to the provisions of the proposed Div 83A contained in the Budget Measures, because employee options and shares falling under the new provisions are to be taxed when they *vest* to the employees, rather than when they are *exercised* by the employees.

Furthermore, under the new provisions, even if the employee's options are "underwater" and "out of the money", employees may still incur unexpected, unwanted and, it would seem, unfair taxation liabilities.

These consequences could impose substantial taxation burdens on employees, who may be in no financial position to access additional funding to meet these additional taxation liabilities.

If employees are aware of the potential taxation burdens, these scenarios are likely to discourage them from taking up the options in the first place.

The critical problem arising here is that most employees are unlikely to have the additional funds to pay the tax on those unexercised options. Where options are "out of the money" due to depressed share prices, employees, logically, will not exercise the options because they would need to make up the difference between the exercise price and the reduced share price.

Summary

Assume a company decides to issue options to its employees for no consideration (ie at a discount to market value), with a 7-year duration, which fall under the qualifying deferred provisions of proposed Div 83A (ie s 83A-120(7), with a strike price at market value of \$1 vesting at the end of year 3. If the company's share price experienced a fall in share values, the following taxation consequences would occur:

- a 40 cent share price would produce an employee taxable value of nil; and
- a 90 cent share price would produce an employee taxable value of 3.3 cents per option (ie income tax of 1.53 cents at the top marginal tax rate of 46.5%).

As mentioned above, those arrangements are very typical of option arrangements operating in many large companies listed on Australian Stock Exchanges.

One should note that this tax trigger applies when the options vest to the employees irrespective of whether the employee exercises or does not exercise the options.

Detailed analysis

Under proposed reg 83A-315.01, in determining the taxable value of the right (i.e. the option) upon vesting, the employee would have a *choice* of:

- (A), the market value of the right; or
- (B), the tabulated values under regs 83A-315.02 to 83A-315.09.

Assumptions

We have made the following assumptions in our analysis:

- the issued options fall under the qualifying deferred provisions of proposed Div 83A;

- a 7-year Option life;
- a share price of \$1;
- a strike price of \$1;
- options have a 'real' risk of forfeiture (ie subject to time and profit hurdles); and
- the options vest at the end of year 3 (ie assuming the profit hurdles have also been achieved).

The employee's marginal tax rate is assumed to be 46.5%.

Market value

In regard to (A) above, the employee could utilise a Black Scholes Merton valuation methodology in accordance with accounting standard AASB2.

Assuming the share prices fell to 40 or 90 cents at the end of year 3, we have provided Black Scholes Merton market valuations based on the RSG Employee Share Option Calculator.

We have assumed a volatility factor of 32%, a risk-free rate of 4.2%, a lost dividend yield of 4%, and a staff turnover of 5%.

Utilising the RSG Equity-based Remuneration Toolkit calculator, our market valuations and taxable values are as follows:

- the option value with a share price of 90 cents would produce a valuation of 16 cents (refer Table 1 Scenario 1 at the end of this article); and
- the option value with a share price of 40 cents would produce a valuation of 1.03 cents (refer Table 1 Scenario 2 at the end of this article).

Regulated tabulated values

In regard to (B) above, utilising the tabulated values, if the share price fell to 40 cents at year 3, the taxable value would be nil, because the calculation percentage for the 40 cent share price is 40%, and would be less than 50% (refer proposed s 83A-110(2) of the ITAA 1997 and reg 83A-315.07).

However, if the share price fell to 90 cents at year 3, under the tabulated values, the employee would have a taxable value of 3.3 cents, need to pay income tax of 1.03 cents (ie at the 46.5% rate, per proposed s 83A-110(2) and reg 83A-315.08).

Therefore, if the options vest at the end of year 3:

- a 40 cent share price would produce an employee taxable value of nil; and

- a 90 cent share price would produce an employee taxable value of 3.3 cents (income tax of 1.53 cents at the top marginal tax rate of 46.5%),

Furthermore, if the share values at year 3 were to be:

- 92.5 cents, the employee's taxable value would be 5.4 cents (tax of 2.5 cents);
- 95 cents, the employee's taxable value would be 6.6 cents (tax of 3.07 cents);
- 97.5 cents, the employee's taxable value would be 8 cents (tax of 3.72 cents);
- \$1, the employee's taxable value would be 9.5 cents (tax of 4.42 cents);
- \$1.025 the employee's taxable value would be 11.1 cents (tax of 5.16 cents);
- \$1.05 the employee's taxable value would be 12.9 cents (tax of 6 cents);
- \$1.075 the employee's taxable value would be 14.7 cents (tax of 6.84 cents); and
- \$1.10 the employee's taxable value would be 16.5 cents (tax of 7.7 cents).

It would clearly be in the employee's best interest to choose the concessional tabulated values under regs 83A-315.02 to 83A-315.09.

Note: as mentioned above, this tax trigger applies whether the employee exercises or does not exercise the options.

Practical example

John Knight works as the Financial Controller of a large mining company (LMC). LMC offers John 250,000 options with a strike price equal to the prevailing share market price of \$10. The options have a 7-year life and vest after 3 years.

If at the end of year 3, John's options vest and the share price is \$11, John will be taxable under proposed s 83A-110(2), and will be liable for income tax of \$191,813. If John exercises his options, he will realise a gross gain of \$250,000 from which he will need to pay the income tax of \$191,813, giving him a net gain of \$58,187 (ie an effective tax rate of 330%).

If the shares experienced "crab" market conditions at the time of vesting and had no growth (ie the share price remained at \$10), John would realise *no* gain on his optionholding, he will probably not exercise his options but he would still be required to pay income tax of \$110,438. The question is, where does John get the \$110,438 from to pay the additional income tax?

If the shares experienced "bear" market conditions at the time of vesting and the share price fell to, say, \$9.50, again, John would realise *no gain* on his optionholding, but he would still be required to pay income tax of \$76,725. Again, the question is, where does John get the \$76,725 to pay the additional income tax?

Conclusion

Even taking into consideration the concessional taxable values produced by the regulated tabulated values, which have been continued (albeit temporarily) under the proposed provisions of Div 83A, certain value price scenarios will cause substantial tax and financial problems for employees taking up options offered by their employer.

The problem arising here is that employees would have no additional funds to pay the tax. They would not exercise the options because they are "underwater" and would need to make up the difference between the exercise price and the reduced share price.

Disturbingly, under the typical option arrangement outlined, the share price at year 3 would need to be at least \$1.09, for the employee to cashless exercise, pay the exercise price of \$1 *and* the income tax of 8.6 cents. The employee would also obtain *no* benefit under this scenario.

It would also act as a major disincentive for participating employees to increase shareholder value beyond 50% of the exercise price, in a company suffering falling share values.

One should also note that the Government has announced its intention to review the concessional regulated tabulated values for options with a view to increasing those values, which would exacerbate this existing disincentive.

Companies need to review very carefully their employee share and option plans in the light of the new legislation and, if necessary, amend those plans to ensure employees are not subject to unforeseen taxation consequences. This is especially relevant where employees receive little or no return on their optionholdings and incur debilitating taxation liabilities, detrimental to the financial security of the companies, the employees themselves and their families.

Companies should also review their governing plan documentation, given that s 83A-115 now requires a "real" risk of forfeiture and "genuine" restrictions on disposal of the equity.

Upon review, companies may wish to amend or replace their existing employee share and option arrangements. Certain alternative qualifying arrangements and non-qualifying arrangements will deliver much better and more secure financial consequences for participating employees. Many long-standing corporate share and option arrangements may need to be replaced in this current taxation environment.

This would be a major disincentive, deterring the employees from taking up the options in the first place, if they were fully aware of the potentially detrimental taxation consequences of their participation in the plan.

Table 1 - Equity-based Remuneration Toolkit		
	Scenario 1	Scenario 2
Company	LMC	LMC
Date	28 Oct 2009	28 Oct 2009
How many shares	1	1
Financial period	1/7/2009 - 30/6/2010	1/7/2009 - 30/6/2010
Share price	\$0.90	\$0.40
Strike price	\$1	\$1
Call life	4 years	4 years
Vesting period	0 years	0 years
Volatility	32% pa	32% pa
Risk-Free rate	4.2% pa	4.2% pa
Lost dividend yield	4% pa	4% pa
Staff turnover	5% pa	5% pa
Exercise multiple	2	2
Marginal tax rate	30%	30%
Call Option Value	\$0.16	\$0.0103
After-tax cost	\$0.112	\$0.0072
Pre-tax value	\$0.2286	\$0.0147

[Gary Fitton is author of the "Salary packaging and remuneration strategies" and "FBT and financial planning" chapters of the **Thomson Reuters Australian Financial Planning Handbook.**]