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Executive share schemes

Structuring, taxation and investment strategies

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An employee share scheme is often the single most important source of wealth generation for an executive over their working life. Employee share schemes come in different forms with different potential outcomes. It is critical for executives to maximise the opportunities provided by this wealth creation tool, to have the right structures with the right entities and the right strategies in place for this most important source of future wealth.

Despite the fact that employee share schemes are often the most significant source of wealth generation, the vast bulk of the executives we speak with have found it difficult to cut through the inherent complexity of employee share schemes and maximise the opportunities for wealth generation these schemes represent.

This paper aims to:

1. help busy, time-poor executives be aware of and understand the complexity that is often embedded within employee share schemes
2. provide an overview of how these schemes work in practice
3. assist executives to maximise opportunities by using the right structuring, tax and investment strategies.

An employee share scheme offers executives equity in the company or the opportunity to purchase shares in the company at a later date (known as a share options plan).

The tax treatment of the employee share schemes can be complex in nature. This paper seeks to clarify such implications.

Further, it discusses different vesting schemes and financial strategies to help executives achieve their objectives; whether it be wealth creation, asset protection and/or tax optimisation.

Strategies for consideration when participating in employee share schemes are:

a) structuring for tax optimisation and asset protection
b) benefits of diversification
c) liquidity issues and cash flow requirements
d) evaluating loan arrangements
e) start-up tax concessions.

Seeking specialist advice is crucial to navigating the terms and conditions before entering an employee share scheme.

Cutting through the complexity

The primary source of wealth for many senior executives is often from the receipt of shares via an employee share scheme. Therefore, it is critical for executives to understand how these schemes work in practice and to cut through the complexity of the various terms, conditions and tax treatments.

Once an executive develops a good understanding of how these schemes work, they can consider specific wealth and investment strategies to help maximise their opportunity to preserve and grow wealth.

As mentioned, an employee share scheme provides employees with equity in the company—either as outright shares or as the opportunity to purchase discounted shares in the company at a predetermined date in the future (known as a share options plan).

Employee share schemes are used by companies to attract, retain and motivate employees. These schemes are designed to align the shareholders' interests with the employees' interests, as both groups can benefit financially if the company performs well over the long term.

Employee share schemes offer executives shares of the company for a discounted price. The shares can be paid through salary sacrificing, using the dividends received from the shares or be paid upfront often using a debt facility arranged by the employer.

Vesting and restricted share schemes

A vested share is one that an executive can act on and sell. Companies implement share vesting schemes to retain employees, incentivise them to perform and mitigate the risk of giving away too much equity in case an employee decides to leave earlier than expected.

A company can award ordinary shares under a restricted share plan, subject to satisfaction of specified time-based and/or performance-based vesting conditions. Shares acquired under a restricted share plan at a discount to market value will be taxed when the shares are granted, unless a tax concession is available (see tax treatment in the next section of this paper).

Generally, shares are granted subject to meeting specified time-based or performance-based vesting conditions. Most often, shares vest based on the length of time to the company. That is, a time-based vesting condition. A common vesting period is three to five years. A vesting schedule is set up by the employer, and determines when executives can acquire full ownership of the shares.

Shares can also be granted if the executive satisfies specific performance conditions such as individual performance metrics and/or company performance metrics like total shareholder return, return on equity or growth in earnings per share.

Tax treatment of shares received through an employee share scheme

Division 83A of the *Income Tax Assessment Act 1997* identifies the tax implications of employee share schemes. The general principle is that executives will be taxed (according to their individual marginal tax rate or the marginal tax rate of the entity that owns the shares) on any discount to the market value received.

The discount refers to the difference between the market value at the time of vesting and the cost base. In other words, the amount executives are paid to acquire their shares. The discount forms part of their assessable income and needs to be included in their personal tax return.

Depending on the type of employee share scheme offered, the discount income amount of any shares will either be taxed at the time the shares are granted or deferred so that any tax is payable at a later point in time.

Tip: Executives can use the Australian Taxation Office's online employee share scheme (ESS) calculator to help calculate the discount received from their employee share scheme. Note: while this tool is a helpful guide for calculating the discount amount for relatively simple ESS scenarios, it does have limitations. Be sure to read about these limitations and, as always, it is best to speak with a tax adviser about one's personal circumstances.

Under a tax-deferred scheme, an employee can defer paying tax until the financial year in which the deferred taxing point occurs, instead of paying tax in the financial year the shares are acquired. To be eligible for a tax deferral, the scheme and employee must meet specific conditions of the tax-deferred scheme.

If an executive decides to dispose of their shares within 30 days after the deferred taxing point, the deferred taxing point becomes the date of that disposal. This is known as the 30-day rule.

Executives should be mindful of this rule before disposing of shares. In some situations, the 30-day rule will bring forward the deferred taxing point to the previous financial year. This may pose cash-flow issues for executives later down the track.

Capital gains tax (CGT) implications depend on what type of entity owns the shares. In relation to CGT, the 50% CGT discount applies if the shares have been held for at least 12 months before they are sold. CGT should then be assessed on 50% of any capital gain realised on sale. If there is a capital loss, the losses can be carried forward for future financial years.

Maximising the opportunity

Employee share schemes can be an effective way for executives to maximise their long-term wealth, however, they should consider how the scheme fits into their broader wealth planning and investment strategy before deciding to participate in such schemes.

The following section of the paper discusses strategies to help executives maximise the opportunity to grow and preserve their wealth as well as how best to optimise tax and structuring.

Structuring for tax optimisation and asset protection

Generally, executives are on a higher marginal tax rate and should consider owning the company shares in a family trust or self-managed superannuation fund (SMSF). It is important to consider both the income and CGT implications, asset protection and access to capital before choosing the right entity in which to own the shares.

The quote

Employee share schemes offer executives shares of the company for a discounted price.

If an executive has already entered an employee share scheme in their personal name, they can consider transferring the shares to a different entity, however, they need to be careful of the CGT impact. When an executive transfers shares from their name to an entity such as a trust (after the shares have vested), the company will typically need to approve the transfer. The company may also like to see that the executive is still the controlling person.

For some individuals, owning the shares in their personal name may be a feasible option if the shares are granted immediately or via a loan-funded arrangement (see section about loan arrangements on the following page of this paper) or options exercised personally and then transferred.

If an executive chooses to own their shares in their SMSF, the lower-tax environment in superannuation will likely be in their favour. While an executive is still working or accumulating wealth to spend in retirement (that is, they are in 'accumulation phase'), the income tax on the dividends paid is 15% and the CGT is also 15%; though if the executive has held the investment for more than 12 months, then realised capital gains are taxed at only 10%. In retirement (that is, 'pension phase') the income tax and CGT are nil, provided the member's pension balance does not exceed $1.6 million.

Although there can be significant tax advantages of holding shares in superannuation (especially if the executive has a long investment timeframe), access to capital and the number of years until an executive retires should be considered. The lack of access to capital may pose a problem if an executive has near-term cash flow requirements, such as purchasing a new home.

Another option is to own the shares in a family trust. In addition to having access to capital, another advantage of a family trust is that the trustee has the discretion to distribute and split the income (in this case, the dividends from the company shares) to beneficiaries with lower marginal tax rates, such as their spouse or children over 18 years of age. Splitting the income between different beneficiaries can be an effective way of reducing tax.

A further benefit of owning the company shares in a family trust or SMSF is asset protection. Executives, particularly company directors, can be at risk of being potentially sued for breach of director duties, and therefore owning shares in a discretionary family trust or SMSF can offer additional asset protection and the peace of mind that comes with it.

Another suitable option could be owning a portion of shares in an SMSF (for retirement savings and favourable tax outcomes) and the remaining portion of shares in a family trust (for income splitting, asset protection and access to sale proceeds). This diversified strategy allows executives to take advantage of the tax benefits in superannuation, while having access to the funds (once vested) via a family trust.

Different share schemes may result in different outcomes.

Example 1. Treatment of grants/acquisitions to superannuation funds

One of the challenges in having employee shares granted into a superannuation fund is dealing with how that grant/acquisition to the superannuation fund can occur and how it will be treated for and by the superannuation fund.

It is important to know if the share dividends include franking credits as well as CGT consequences when choosing the right structure to hold the shares.

Example 2. The benefits of franking credits

Distribution of income from a trust to a corporate entity will typically lead to no additional tax at that point when the dividends are fully franked.

Benefits of diversification

If an executive is given the offer to participate in an employee share scheme, it is important that the shares are considered as part of their overall diversified investment strategy to avoid concentration risk in one single asset position.

There could be significant upside for executives participating in employee share schemes, especially when offered at a significant discount. While it is often good to have 'skin in the game', executives should be aware of the impact this can have on a portfolio's level of diversification.

Harnessing the benefits of good diversification requires executives to make a fundamental shift in mindset to accepting that, from a wealth management perspective, good diversification means investing in strategies that are deliberately uncorrelated to the returns of the company shares.

Portfolio optimisation and good diversification require an investor to hold exposure to a range of asset classes and to avoid overexposure to any one particular investment or asset class.

Diversification across asset classes is the academically proven method of achieving optimal risk-adjusted returns as shown in economist and Nobel Prize Laureate Harry Markowitz's 1952 paper 'Portfolio selection', in which he pioneered modern portfolio theory.

An ideal strategy would be to construct portfolios that offer better upside-downside capture relative to the median manager and diversified benchmarks, and importantly the portfolios also generate uncorrelated returns relative to traditional equities and bond market exposures.

Liquidity issues and cash flow requirements

There can be limitations on when executives can access and transact their shares. Firstly, the shares must have vested (usually according to a certain number or years or meeting specific performance targets as discussed in the previous section) before they can be accessed or sold.

If the shares are listed in public markets such as the Australian Securities Exchange, there is often an annual trading window when employees can sell their shares. Further, there could be other liquidity constraints if the shares are privately owned and unlisted.

Previously, we discussed the fact that executives are taxed on any discount to market value received. Although unintended, participating in an employee share scheme could impose cash-flow issues because a tax liability could arise if they are unable to fund the liability due to the illiquidity of the shares.

Due to the illiquidity company shares often have, it is not prudent for an executive to allocate the shares as part of their diversified 'liquid bucket' in case of an emergency or upcoming large expense

such as a down payment on a mortgage. Prior to participation in an employee share scheme, it is important for an executive to consider their own financial circumstances and cash-flow requirements. For instance, they may have other priorities like paying off their non-deductible debt or contributing towards their superannuation for a comfortable retirement.

Executives should also be aware of situations where they decide to pay tax upfront and the value of the shares reduces by the time they vest.

Considering loan arrangements

Under a vesting loan arrangement scheme, executives are provided with a limited recourse loan to acquire shares at market value and repay the loan amount. Given that the shares are acquired for market value, CGT provisions will apply.

The employer can provide an interest-free loan, however, fringe benefit tax (FBT) may be payable by the employer, so executives should speak with their employer and tax adviser about any potential FBT impact. Executives should also check with their tax and structuring adviser regarding whether Division 7A dividends or FBT has precedence, the application of the otherwise deductible rule as well as the loan forgiveness provisions if the loan ends up being more than the share value.

Dividends paid on the shares can be applied against the outstanding loan balance (net of income tax on the dividends). It is generally expected that executives will receive franking credits, however, they should consider the 45-day rule and speak with their tax adviser about utilising franking credits in the right entity. The 45-day rule requires shareholders to have held the shares for at least 45 days to be eligible to claim franking credits in their tax returns.

The key advantage of a loan arrangement is that the income tax (from the shares rewarded to the executive) can be deferred and does not have to be paid upfront, which can have cash-flow benefits. It is suggested that executives speak with their employer and tax adviser to determine if a loan arrangement is suitable to their personal circumstances and objectives.

Start-up concessions

If an executive works for a start-up and has participated in an employee share scheme or options plan, they may be eligible for start-up concessions if certain conditions are met. Under the start-up concession rules, employees of Australian start-up companies can reduce the assessable discount on options granted on or after 1 July 2015 to nil.

In the previous section of the paper, we discussed that the discount (difference between the market value and cost base) forms part of assessable income and needs to be included in a personal tax return. In respect of start-up concessions, the discount is not subject to upfront taxation. However, CGT is still assessed (note: the 50% CGT discount can be applied).

Start-up concessions are subject to specific conditions for both the employee and the firm. Some of these conditions are as follows:

a) The firm must not be listed on a stock exchange and must have been incorporated within the past 10 years.
b) The firm's aggregated turnover must not exceed $50 million.
c) The employer is an Australian resident company.
d) An employee must hold their employee share scheme interests for at least three years and cannot hold more than 10% of the total shares in the company.

The start-up concession is essentially a tax-deferral mechanism which also provides tax efficiency for executives and founders of start-ups. There could be other conditions in relation to start-up concessions that apply to various circumstances, so it is best for an executive to check with their employer and a tax specialist.

Conclusion

As outlined in this paper, the structuring, tax consequences and financial strategies of employee share schemes can be complicated. By having the right strategy and structure in place from the outset, an executive will reap the benefits later down the track and can realise meaningful wealth creation opportunities. **FS**