EXECUTIVE SHARE SCHEMES
Maximising the Opportunity

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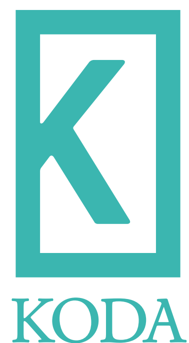
November 2019 – 2nd Edition



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 an executive to maximise the opportunity for 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.

"Good fortune is what happens when opportunity meets with planning"

Thomas Edison

CONTENTS

Executive Summary 4

Cutting through complexity 5

Maximising the opportunity 7

Why seek specialist advice? 11

Why Koda Capital? 11

General Advice Warning: Any views expressed in this paper have been prepared without considering your objectives, financial situation or needs. Before acting on any advice in this document, Koda Capital Pty Ltd recommends that you consider whether this is appropriate for your circumstances.

The material discussed in this paper is general in nature and should not be regarded as specialised taxation advice. It is not intended as a complete assessment of your liabilities, obligations or entitlements that arise, or could arise, under taxation law. Koda recommends that you consult with your tax adviser or agent for specialised tax advice.

Executive Summary

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 at Koda Capital have found it difficult to cut through the inherent complexity of employee share schemes and maximise the opportunity for wealth generation these schemes represent.

The aim of this paper is to:

1. Help 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 the opportunity 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 and we aim to simplify the tax implications in this paper.

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

The strategies we consider when participating in employee share schemes are outlined below:

- **a)** Structuring for tax optimisation and asset protection
- **b)** Benefits of diversification
- **c)** Liquidity issues and cash-flow requirements
- **d)** Considering loan arrangements
- **e)** Start-up tax concessions

Further, we discuss why specialist advice in this area is crucial and consider the value in working with a trusted adviser to navigate the terms and conditions before entering an employee share scheme.

This paper is designed to support busy and time-poor executives with their wealth planning and investment strategy.

This paper is broken into four areas:

1. Cutting through complexity
2. Maximising the opportunity
3. Why specialist advice?
4. Why Koda Capital?

Part I: Cutting through complexity

INTRODUCTION

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.

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 a share vesting scheme 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 section below).

In general, 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, i.e. a time-based vesting condition. A common vesting period is three to five years. A vesting schedule is set up by the employer which determines when executives can acquire full ownership of the shares.

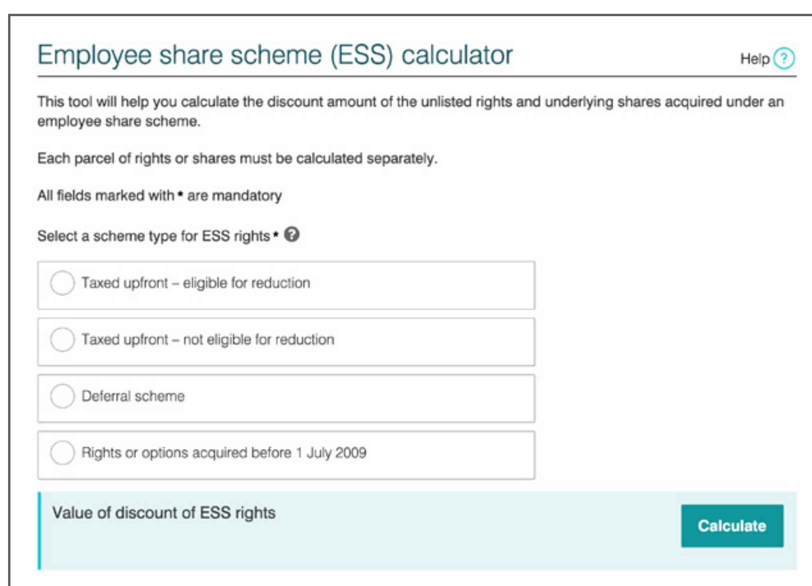
Shares can also be granted if the executive satisfies specific performance conditions such as individual performance metrics and/or company performance metrics such as total shareholder return, return on equity or growth in earnings per share.

WHAT IS THE TAX TREATMENT OF SHARES RECEIVED THROUGH AN EMPLOYEE SHARE SCHEME?

Division 83A of the Income Tax Assessment Act 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.

Executives can use the ATO's online 'Employee share scheme (ESS) calculator' (available at this link) to help them calculate the discount received from their employee share scheme. Note: whilst 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 the limitations of the tool and, as always, it is best to speak with a tax adviser about your personal circumstances.



This tool is available at ato.gov.au/calculators-and-tools/employee-share-schemes-calculator/

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.

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

In relation to capital gains tax, the 50% CGT discount applies if the shares have been held for at least 12 months before they are sold. The 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.

CGT implications depend on what type of entity owns the shares. Executives should seek specialist taxation advice specific to their personal circumstances before entering into an employee share scheme.

Part II: 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 the scheme.

In this section of the paper we discuss 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 super fund (SMSF). It is important to consider both the income and capital gains tax implications, asset protection and access to capital before choosing the right entity to own the shares.

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 capital gains tax 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 loan funded arrangement (see details about loan arrangements in this section below) or options exercised personally and then transferred.

If an executive chooses to own their shares in their self-managed super fund, the lower tax environment in super will likely be in their favour. While an executive is still working or accumulating wealth to spend in retirement (ie they are in 'accumulation phase') the income tax on the dividends paid is 15% and the capital gains tax (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 (ie 'pension phase') the income tax and CGT are nil provided the member's pension balance does not exceed $1.6m.

Although there can be significant tax advantages of holding shares in super (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.

An additional benefit of owning the company shares in a family trust or self-managed super fund is for 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 self-managed super fund 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 a self-managed super fund (for retirement savings and good 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 super, while having access to the funds (once vested) via a family trust.

Different share schemes may result in different outcomes. For example, one of the challenges in having employee shares granted into a super fund is dealing with how that grant/acquisition to the super fund can occur and how it will be treated for and by the super fund.

It is important to know if the share dividends include franking credits as well as the capital gains tax consequences when choosing the right structure to hold the shares. For example, 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.

Executives should speak with a tax and structuring specialist who is well versed in relation to these rules as well the executive's personal circumstances and objectives. Koda Capital's Structuring and Tax team provides tailored advice that addresses an executive's structuring, investment strategy, tax, lifestyle, succession, and estate planning needs.

In general, 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, i.e. a time-based vesting condition. A common vesting period is three to five years. A vesting schedule is set up by the employer which 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 including total shareholder return, return on equity or growth in earnings per share.

BENEFITS OF DIVERSIFICATION

If an executive is offered 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. Whilst 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.

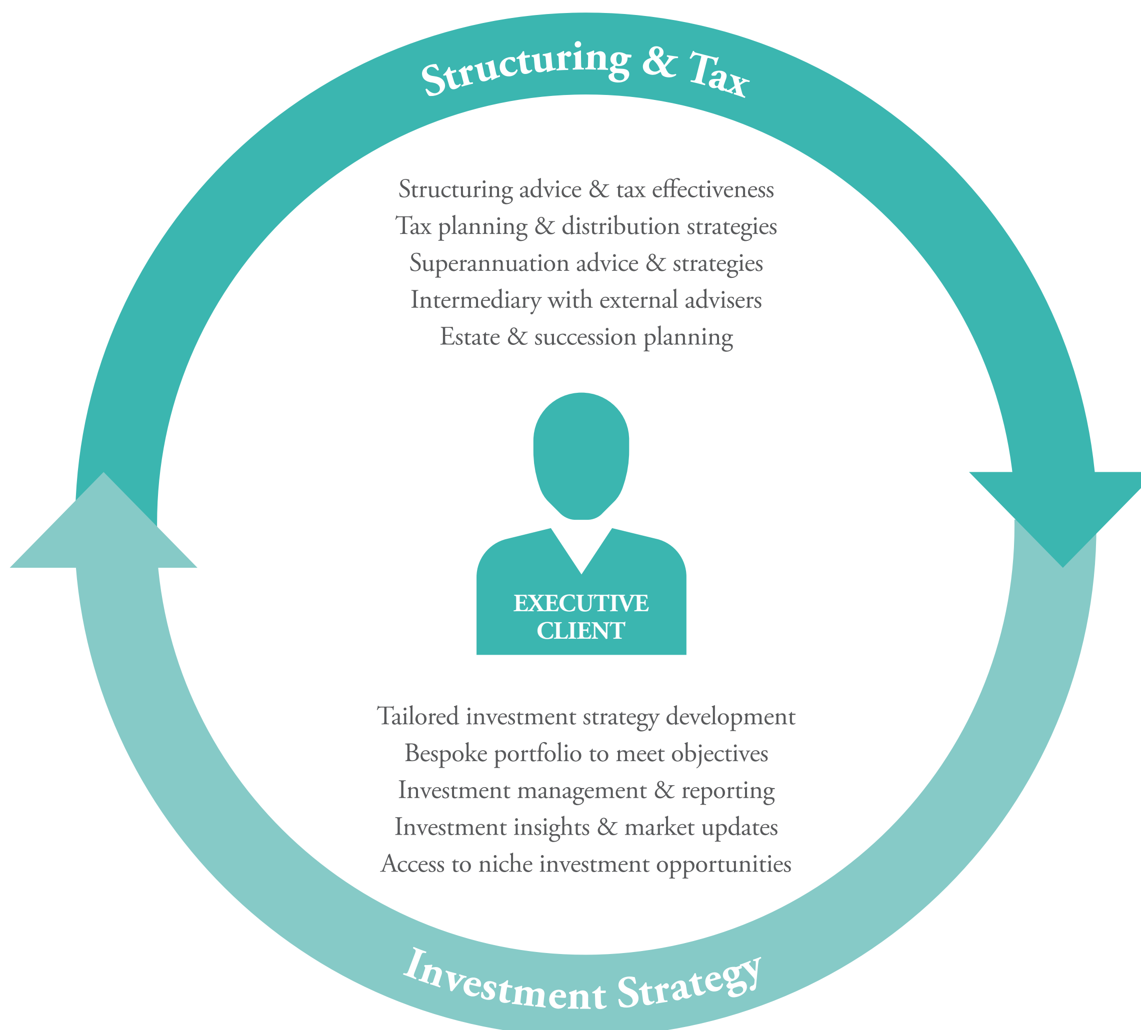
Harnessing the benefits of good diversification requires executives to make a fundamental shift in mindset to accepting that, from a wealth management perspective, good diversification means investing in strategies that are deliberately uncorrelated to the returns of the company shares.

Portfolio optimisation and good diversification require an investor to hold exposure to a range of asset classes and to avoid over-exposure to any one particular investment or asset class.[1]

Koda Capital's Investment Strategy Group helps 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.

1. 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 paper *Portfolio Selection*, in which he pioneers Modern Portfolio Theory.

Koda Capital offers core services across four areas: Structuring & Tax, Investment Strategy, Philanthropy & Social Capital and Family Leadership. In combination, these services deliver financial peace of mind to each of Koda's clients. In the case of Executive Share Schemes, a Koda Adviser can work with an executive client to make sure structuring and investment strategies take into account employee shares as well as personal circumstances.



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 ASX, there is also often an annual trading window when employees can sell their shares. There could additionally 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 as the 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 example 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 reduce in value by the time they vest. There are specific strategies to help manage this situation and Koda Capital's Structuring and Tax team can provide tailored advice to address this issue.

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, the capital gains tax provisions will apply.

The employer can provide an interest free loan, however fringe benefit tax (FBT) may be payable by the employer and executives should speak with their employer and tax adviser about any potential FBT impact. Executives should 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 executives 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. We suggest 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 to 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 their assessable income and needs to be included in their personal tax return. With respect to start-up concession, the discount is not subject to upfront taxation. However, capital gains tax is still assessed (note that 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 include:

- **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 $50m
- **c)** The employer is an Australian resident company
- **d)** An employee must hold their employee share scheme interests for at least 3 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.

Part III: Why seek specialist advice?

Employee share schemes can be difficult to understand, as these schemes often include complex terms and conditions. Therefore, executives should carefully read the offer documents and consider working with a specialist adviser to help them navigate through the complexity.

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 start, an executive will reap the benefits later down the track and can avoid missing out on meaningful wealth creation opportunities.

Part IV: Why Koda Capital?

Appointing a firm to take on the role of managing wealth is understandably a significant decision for executives.

Partners at Koda Capital specialise in advising executives on how to optimise their wealth planning and investment strategy by utilising Koda's specialist knowledge, expertise and research.

One of the key foundations Koda has put in place is a fiercely independent partnership model, unaligned to any financial institution or product 'manufacturer', meaning the firm's sole revenue comes from fees for advice. This structure eliminates the potential for any conflicts of interest. Koda's commitment to clients is very clear:

> Our commitment to clients highlights what we stand for as a business and ensures we deliver on our promise of Koda's name - being our client's 'friend or ally'. Our independence is core to our promise to our clients, to the profession, and to ourselves.

We hope you found this white paper valuable in your own wealth planning and investment strategy. Please do not hesitate to contact us if you have any questions or comments.

HOW TO USE THIS PAPER

- Contact us to discuss appointing Koda as your tax and structuring adviser
- Use it as the basis of a conversation with your current advisers
- Share it with your executive team and board of directors
- Send it to other executives in your network via email or LinkedIn

About the Author

Sabil is an Adviser and Partner at Koda Capital and has worked in financial services since the mid-2000s. As an Adviser, Sabil helps executives, company founders and family offices to preserve and grow their wealth.

His specialisations include providing advice on customised investment mandates, strategic/tactical asset allocation, alternative investments, managing liquidity events, employee share schemes, share option plans, structuring and tax strategies.

Before joining Koda, Sabil was a Private Wealth Adviser at Macquarie Private Bank, providing holistic wealth management and investment advice to high net worth executives, entrepreneurs and family offices. Prior to that he had advisory roles at Perpetual Private Wealth and KPMG Risk Advisory.

Sabil holds a Bachelor of Mathematics from the University of New South Wales, Master of Management (Graduated with Distinction) from the University of Sydney Business School and Diploma of Financial Planning (RG146) from Kaplan including accreditations in SMSF, Gearing/Lending and ASX Derivatives Levels I and II.

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