TAX IMPLICATIONS OF PROPOSED EXECUTIVE REMUNERATION REFORMS

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Amid the global recession and significant negative public sentiment against excessive executive remuneration practices, the Federal Government has mandated the Productivity Commission to examine Australia's framework for executive remuneration, including the tax treatment of equity based remuneration. In addition, the Government has proposed reforms to significantly broaden the circumstances in which shareholder approval of executive termination payments is required. This article examines the taxation aspects of the reform proposals.

PROPOSED REFORM OF EXECUTIVE REMUNERATION

The Federal Government has asked the Productivity Commission to examine Australia's framework for the remuneration of directors and executives.[1] The Commission is scheduled to report on its findings in December 2009 after seeking public consultation and submissions.

The Terms of Reference for the Productivity Commission refer to the current global financial crisis as highlighting the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed, but that reward structures need to be internationally competitive and continue to provide incentives for directors and executives. In this light, the Commission has been asked to consider:

- trends in director and executive remuneration in Australia and internationally;
- the effectiveness of the existing framework for the oversight, accountability and transparency of director and executive remuneration practices in Australia;
- the role of investors such as large local institutional shareholders in Australia (eg superannuation funds) and retail shareholders in the development, setting, reporting and consideration of remuneration practices;
- any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community, including the role and structure of equity based payments and incentive schemes, including their tax treatment;[2] and
- the effectiveness of the international responses to remuneration issues arising from the global financial crisis, and their potential applicability to Australian circumstances.

The review is in addition to, and is intended to complement, the work of the Australian Prudential Regulation Authority in developing a template for financial institutions which links capital adequacy requirements to executive remuneration practices in order to limit excessive risk taking.

TAX AND LONG–TERM INCENTIVES

Many of the criticisms of executive remuneration packages of late have focused on concern over the lack of alignment between remuneration and long–term company performance as evidenced by the increase in short term incentive plans and termination payments. There is a strong likelihood that the Productivity Commission's findings and recommendations will address this trend by encouraging long–term incentives such as those recently announced by the Australian Shareholders Association (ASA) in its updated policy statement on executive remuneration released on 23 March 2009.

The ASA policy statement encourages companies to reward superior rather than satisfactory performance and indicates a strong preferment to long–term equity incentives rather than short–term incentives. In particular, the ASA has suggested a vesting period of no less than four years and, in particular for CEOs, a holding lock of two years post vesting irrespective of cessation of employment.

Continuing performance testing of unvested equity incentives beyond cessation of employment is generally consistent with other Organisation for Economic Co–operation and Development (OECD) countries. However, it runs counter to the current Australian tax regime for employee equity plans which treats the cessation of employment as a taxing time.[3]

Under the current tax regime, tax is generally payable on employee equity incentives when the employee is able to sell the shares (ie when forfeiture and disposal restrictions no longer apply), based on the market value of the shares at that time. However, curiously, cessation of employment is a taxing time for employee equity incentives, regardless of whether those incentives are vested or able to be sold at that time. That is, the employee is taxed on cessation of employment based on the market value of the shares at that time, disregarding the forfeiture and disposal restrictions that may continue to apply. This amount is subject to tax as remuneration income at the employee's marginal rate of tax in the year of leaving the employment. Where the equity incentives are not, at that time, able to be sold to pay the tax due on those incentives on cessation of employment, the former employee is left in the difficult position of having to source alternative funds to pay this tax bill. This is notwithstanding that there may be no certainty at that time whether the incentives will vest and, if so, what the value of the incentives will be on vesting.

The amount on which tax is payable on cessation of employment may vary significantly from the value of the shares at the later time when the former employee becomes entitled to sell the shares. This difference (whether an increase or decrease) is generally accounted for under the capital gains tax regime on the disposal of the shares. If the incentives are forfeited after cessation of employment, a refund of the tax payable on cessation of employment is generally only available where the employee has not had dividend and voting rights on the shares before that forfeiture has occurred. Even where a refund of the tax paid on cessation of employment is available on a later forfeiture of the equity incentives, the former employee would still have had to source alternative funds to pay the tax bill until the refund of that amount occurs on the later forfeiture.

Example:

In April 2009, Mr Brown the CEO of Blue Co, is granted the right to receive 10,000 ordinary shares in Blue Co. The terms of the grant provide that the shares will vest, subject to satisfaction of performance conditions, on the 4th anniversary of the grant (i.e. April 2013) and any vested shares will be subject to a further two year disposal restriction after vesting. Mr Brown is not entitled to dividends or voting rights with respect to the shares until vesting.

Mr Brown does not elect to be taxed on the shares in the year of grant.

If the Productivity Commission encourages long–term incentives with performance testing continuing regardless of the executive ceasing employment then, unless the tax laws are amended to remove cessation of employment as a taxing time, executives may have to fund the tax on the awards significantly in advance of when they are able to sell the shares and despite the risk that the awards may not vest or may be forfeited.

The Australian Taxation Office is taking a very restrictive view of the transitional rules, including the view that the concessions will not apply where the contract is varied or amended to freeze or otherwise limit the amount of the termination payment and where the contract is replaced notwithstanding there is no change to the termination payment entitlement.

In April 2011, two years after the grant, Mr Brown retires from office when the market value[4] of Blue Co shares is $3.00. Mr Brown is taxed at his marginal rate of tax for the year ended 30 June 2011 on the total value of his unvested shares, i.e. $30,000 in the year he ceases employment.

In April 2013, the vesting date for the shares, the performance conditions are not fully satisfied, so that only 3000 shares actually vest. Mr Brown amends his tax return for the 2010–11 year to reduce the value on which he was taxed to $9000 (ie 3000 x $3.00) and gets a refund of the tax paid on the 7000 share rights forfeited.

Mr Brown is unable to sell his 3000 vested shares for a further 2 years. In April 2015, when Mr Brown is able to and sells his shares, the market value of Blue Co shares is $1.00. Mr Brown sells his shares for $3000. He realises a capital loss at that time of $6000, being the difference between the $9000 value on which he was taxed in 2010–11 tax return and the amount received for his shares.

In this scenario, Mr Brown will have sold his shares as soon as he was entitled to under the terms of the plan. He will have only received $3000 in respect of his shares, but he will have had to pay tax on $9000 (so is likely to have a tax bill in excess of his sale proceeds) and also a requirement to fund a tax bill on a further $21,000 of deemed income (7000 forfeited rights x $3) for more than 12 months before a refund entitlement arose as a result of those rights not vesting.

Australia may be considered 'unique' in seeking to tax equity incentives on cessation of employment where those incentives continue to be subject to substantial risk of forfeiture. It is hoped that the Productivity Commission will include recommendations to align Australia's tax treatment with other OECD countries by removing cessation of employment as the taxing time. Instead, taxation should occur no earlier than when the incentives are no longer subject to forfeiture, with consideration being given to the appropriate tax treatment which should apply where significant disposal restrictions continue to apply to vested awards after cessation of employment.

In the event that the law is not amended and cessation of employment remains a taxing point, other remuneration structures may be sought to ensure that cessation of employment does not give rise to an inappropriate taxing time for equity incentives which continue to be subject to forfeiture and disposal restrictions after cessation of employment. One such restructure option would be for the equity incentives to provide the grantor with a discretion to settle the awards in either cash or shares.

This discretion is likely to mean that the award is not considered a 'right to shares' for the purposes of the employee share scheme provisions of the tax law,[5] until such time as the cash discretion no longer applies, or shares are delivered. As the award would not be a 'right to shares' on grant, cessation of employment before delivery of the shares should not be a taxing time in respect of the award. However, the inclusion of a grantor cash discretion in these circumstances can have various flow–on corporate law and tax issues[6] to be considered which means that, in many circumstances, it may not be a workable solution to the cessation of employment taxation issue.

REFORM OF TERMINATION PAYMENTS

In addition to the Government's call for a review of the broader framework for executive remuneration, the Government has also proposed specific reforms aimed at curbing excessive 'golden handshakes'.[7]

In particular, it is proposed that:

- the threshold at which termination payments are required to be approved by shareholders will be significantly lowered from up to seven times a director's total annual remuneration package, to one year's average base salary ;
- the class of executives requiring shareholder approval will also be extended to all executives named in the company's remuneration report; and
- the definition of 'termination benefit' will be broadened to catch all types of payment and rewards given at termination.

The effective date of the changes has not been specified but the media release indicates that the changes are not intended to apply retrospectively and should not prevent existing contracts from proceeding.

TAXATION AND TERMINATION PAYMENTS

Under the current tax regime, an employee may be taxed at a concessional rate of tax on the receipt of an employment termination payment[8] of up to $145,000.[9] Amounts in excess of that are generally subject to tax at the top marginal rate of tax. However, termination payments up to $1 million may be taxed concessionally under transitional rules which may apply to termination payments which are paid under a written contract, law or workplace agreement which was in force pre 10 May 2006 and which specifies the amount of the payment, or a way to work out a specific amount of the payment (the transitional termination payment).

Even though existing contracts are not intended to be caught by the Government's proposed golden handshake changes, some companies may seek to restructure particular existing arrangements to better align with current public sentiment. Care needs to be taken to ensure that existing arrangements which might fall within the transitional termination payment taxation concessions are not inadvertently restructured so as to lose the benefit of those concessions. The Australian Taxation Office is taking a very restrictive view of the transitional rules, including the view that the concessions will not apply where the contract is varied or amended to freeze or otherwise limit the amount of the termination payment and where the contract is replaced notwithstanding there is no change to the termination payment entitlement.

FOOTNOTES

1. Joint Media Release No 25 by Treasurer Wayne Swan, the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, Chris Bowen and the Minister for Superannuation and Corporate Law, Senator Nick Sherry, dated 18 March 2009 entitled 'Productivity Commission and Allan Fels to Examine Executive Remuneration'

2. The Commission is asked to liaise with the Australia's Future Tax System Review and the Australian Prudential Regulatory Authority in relation to, respectively, any taxation and financial sector remuneration issues arising out of the review

3. Section 139CA(3) and 139CB(2) of the *Income Tax Assessment Act 1936* (Cth)

4. For the purposes of Division 13A of the 1936 Act

5. Division 13A of the *Income Tax Assessment Act 1936*

6. For example, no ability for participants to choose to pay tax on grant and possible delay of tax deductions for the employer

7. Joint Media Release No 24, by Treasurer Wayne Swan and the Minister for Superannuation and Corporate Law, Senator Nick Sherry dated 18 March 2009 entitled 'Action on Golden Handshakes'

8. This would not generally include STI/LTI payments, even where the payment or vesting of those amounts is brought forward on cessation of employment

9. Indexed annually and in addition to the tax free component of bona fide redundancy payments and approved earlier retirement schemes

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