PEPOs Unexpectedly Face FBT

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Introduction

Since the new employee share scheme (ESS) taxing provision came into effect in 2009 one of the viable alternatives available for offering equity to executives and non-executive directors (NEDs) has been premium exercise price options (PEPOs). A PEPO arises when the exercise price of the option is set at a premium to the share price at the time the option is granted. When PEPOs contain certain conditions they have a nil taxable value at grant for ESS taxing purposes. The Australian Taxation Office (ATO) has recently released an interpretation of the taxing laws which accepts that such PEPOs have a no taxable value for ESS taxing purposes but maintains that they are not exempt from fringe benefits tax (FBT) and have an FBT taxable value for which companies are liable for FBT.

Why Are PEPOs Used

At a practical level there is generally no need for any performance or service vesting conditions to be attached to PEPOs because it would usually be expected that the share price increase needed for benefit to accrue in the PEPO would require much of the term of the option to be achieved. This has made PEPOs a very simple and clear cut performance related component of remuneration.

In addition benefits derived from PEPOs qualify for the 50% capital gains tax (CGT) concession, if the sale takes place more than 12 months after the sold equity units were acquired. This generally means that shares acquired by exercising PEPOs need to be held for at least 12 months before sale so as to qualify for the 50% CGT concession. The 50% CGT concession means that half of the capital gain is tax free.

Other advantages of using PEPOs include that vesting does not occur on termination of employment and therefore benefits are not part of retirement benefits that are limited to one year's base salary (unless shareholders approve a higher amount). Also PEPOs can continue to be held after termination of employment which ensures that the business perspective of both executives and non-executive directors is not shortened as they approach cessation of employment with the company i.e. they will not take a short term view to maximise their benefit at termination of employment.

When do PEPOs Have Nil ESS Taxable Value

The conditions that need to be present for a PEPO to have a nil taxable value for ESS taxing purposes are:

1. The exercise price needs to be set at or above the level required to generate a nil value (see table below) when the valuation approach available for ESS purposes in the Regulations is applied,
2. The ESS taxing point needs to be the date of grant which means that there must not be any real risk of forfeiture as such risk defers the ESS taxing point, and
3. The taxpayer needs to elect to use the valuation method in the Regulations.

The premium required to achieve a nil value for the PEPOs varies with the term of the option as indicated in the following table.

Term of Option	1	2	3	4	5	6	7
Premium Required for Nil ESS Value	17.60%	33.34%	48.29%	48.29%	66.67%	66.67%	100.01%

FBT Inconsistency

It had generally been assumed that if a PEPO has a nil value for ESS taxing purposes it would also have a nil value for FBT purposes and in any event there is a provision in the FBT legislation which says that ESS interests are not subject to FBT. This provision seemed to have been inserted to make it clear that the income tax laws and not the FBT laws were to apply to ESS interests.

However, ATO Interpretive Decision ID 2012/68, released in August 2012, indicates that PEPOs with a nil ESS taxable value are not issued at a discount and therefore are not excluded from being subject to FBT – only ESS interests issued at a discount are excluded from being subject to FBT. Such PEPOs are not issued at a discount as they are issued at their value which is nil under the Regulations valuation approach.

The valuation approach in the Regulations that is available for ESS purposes is not available for FBT purposes as it is an income tax regulation and not an FBT regulation. Therefore other valuation methods need to be applied to assess the market value of the PEPOs. Such other valuation methods will almost always produce values that are significantly greater than nil. The relevant value will then be subject to FBT. Of course, FBT is payable by the company and not the executive.

Implication of the Determination

Companies that have been using PEPOs will need to review their FBT liabilities and possibly apply for their FBT assessments to be amended.

Going forward the following approaches should be considered:

1. Continue to use PEPOs but set the premium such that the ESS taxable value, using the Regulation valuation method, is minimal. The size of the discount is not relevant as all that is necessary is that the ESS taxable value be more than nil. This approach will involve a small taxation liability for executives and non-executive directors who are granted PEPOs but this should generally not be a barrier to their use. A premium of say 1% less than any of those shown in the above table would be effective.
2. Continue to use PEPOs and accept that the company is liable for FBT. The value of FBT will be directly related to the value of the PEPOs which will vary depending upon company circumstances and may not be a larger liability.
3. Discontinue the use of PEPOs and replace them with one of the other alternatives. There are several alternatives that should be considered including market exercise price options (MEPOs) – exercise price approximately equals the share price at the time of grant - with appropriate vesting conditions and/or short exercise widows. Others include trust structures which convey the same tax advantages as PEPOs. GRG can provide more information on the alternatives, if required and will be pleased to provide a fees estimate before proceeding.

As the ATO's interpretation appears to be inconsistent with the legislative intent there may be some possibility of an amendment to the FBT legislation. However, it is noted that there has not been any announcement to that effect by the Government at this stage. Thus, future plans should proceed on the assumption that the status quo will continue.