Employee share schemes

Driving performance and retaining talent

Current trends and considerations
for the design of your scheme

May 2023

Employee share schemes

Employee share schemes have been used for many years as a tool to attract, reward and retain talent by offering employees a stake in the companies they work for.

With the exception of start up companies, these are generally positioned as long term incentives ("LTI") schemes. The design of these has changed over recent years in response to a changing landscape in the taxation for employee share schemes.

There are also more obligations on companies to properly assess the value of shares, where these are being provided to employees under such schemes.

In this article we explore:

- Why companies establish share schemes;
- The impact of the 2018 legislative reform regarding the taxation of employee share schemes;
- IRD expectations on companies with respect to the valuation of shares provided to employees in share schemes (CS-17/01);
- A snapshot of listed company share schemes, and recent trends. This includes a broader perspective to include long and short term incentives, including consideration of the types of metrics used to measure performance;
- Considerations for the design of your scheme; and
- For listed companies, the implications of the recent Climate Standard (CS-1) which is placing a disclosure requirement of 'whether and if so, how' climate related performance metrics are incorporated into employee remuneration policies.

Share schemes provide a platform to enhance performance

Introducing a share scheme aligns an employee's interests with those of the business' shareholders. Employee share ownership is an effective way to achieve a number of important business objectives, including:

- Attracting, motivating and retaining key staff. It is widely acknowledged that employee ownership can generate greater employee buy-in, incentivisation and retention because employees have a vested interest in the success of their employer;
- Focusing key staff on attaining the long-term objectives of the business;
- Providing a way to reward performance, or increase remuneration of employees, without impacting on the company's working capital or operating cash-flow position; and
- Providing a way to deal with succession planning of a company through the transition of ownership in a managed way, and to a buyer you can entrust with the future of your business. For instance, where the right candidate exists, share schemes can provide an avenue for an eventual Management Buy Out ("MBO").

Whether or not a share scheme is appropriate for a business will depend on a number of factors, including economic and industry landscape (e.g. how competitive the talent hunt is) as well as where the business is at in its life cycle (e.g. if the founders are looking to exit, or are in need of capital to undertake a significant growth plan). There are also considerations on the impact for existing shareholders, for example the dilutionary impact on dividends once shares vest.

Tax

Tax landscape

In 2018 there was significant legislative reform regarding the taxation of employee share schemes which led to fundamental changes in the structure and design of share schemes.

The changes introduced the concept of a "share scheme taxing date", which has the effect of pushing out the taxing point for employees to the point in time that the employee has full risk and reward of share ownership with no material risk of forfeiture.

While the introduction of the share scheme taxing date has not changed the tax treatment of share option plans, these rules fundamentally changed the tax outcomes of more complex schemes, including in particular those schemes where shares were acquired using loan arrangements. The principal driver for these changes was to ensure that any growth in the value of the awarded shares between grant and the time the employee becomes the full legal and beneficial owner is captured as taxable employment income, rather than being treated as a tax-free capital gain.

As a result of these changes, many tax outcomes which may have been intended at the inception of many plans are no longer achievable, and may lead to unforeseen or misunderstood tax liabilities for employees.

Complex share arrangements are now being phased out in favour of more straight forward and simplified schemes, including share options and rights schemes, which meet the strategic objectives of the company in incentivising and rewarding staff rather than as a tool to provide tax efficient remuneration.

In any share scheme, the specific wording of the plan documentation will dictate how the tax rules apply and the timing of the share scheme taxing date. It is crucial that tax advice is obtained prior to implementing new plans or continuing with pre-2018 plans to ensure that the tax implications are managed and understood.

Corporate tax deduction

The 2018 changes also introduced the ability for businesses to take a corporate tax deduction, equal in timing and amount to the employee's taxable share scheme income, irrespective of whether the shares were bought on market or issued at no cost. This is a significant change for business and ensures that the employer and employee is in the same tax position whether remuneration for labour is paid in cash or shares. There are therefore additional opportunities for companies to assist employees with meeting some of the tax due on share scheme benefits at no after-tax cost to the company.

Complex share arrangements are now being phased out in favour of more straight forward and simplified schemes

Exempt schemes

The use of widely-held tax exempt share schemes are also becoming more prominent as a result of reform in this area and are a way of increasing employee engagement at all levels of the company and aligning employee and shareholder incentives. The exempt scheme requires that shares be genuinely offered to the majority of employees on equal terms, and limits the number of shares offered. If the scheme design meets a prescriptive list of criteria, employees can receive shares in their employer on a tax-free basis.

Reporting and payment of tax

While the obligation to report share scheme earnings of employees through payroll has been in place for some time, given the focus on redesigning share schemes, there has also been an increase in employers opting into managing the PAYE obligations on behalf of employees. Unlike other forms of remuneration, the tax obligations associated with share scheme benefits typically fall to the employee to pay and manage. This can lead to additional complexity, administration and cost for employees and can detract from the benefits of being involved in a share scheme. By ensuring that tax is paid at source, employers can make sure employees avoid the complexities associated with paying provisional tax and terminal tax.

Privately held companies

The following are some tax considerations for share schemes in unlisted companies;

- Given that there may not be the same liquidity in the shares as with a listed entity, consideration should be given to how the employee will fund the tax costs associated with the shares received under an employee share scheme arrangement.
- One option to manage the tax cost is to provide a grossed up bonus to the individual at no after-tax cost to the company (where it is in a tax paying position). The tax impost can be reduced from 39% to 15% through this mechanism.

From a valuations perspective:

- Typically, establishing the value of a share in unlisted entities can cost more, and regular valuations are often required
- To mitigate the costs or preparing regular valuations, some companies choose to by-pass a scheme in favour of management buying into the business from the start. A valuation may still be required to establish that this is as fair value for tax purposes, but it is generally a one-off cost.

Valuation requirements

Companies are required to have a basis for determining the value of shares issued to employees

The Inland Revenue Department released a Commissioner's Statements which provides guidance on the valuation of shares provided for the purpose of employee shares schemes, "CS -17/01 Determining value of "shares" received by an employee under a share purchase agreement".

This statement sets out the expectations for valuing shares and provides examples of methods which would be acceptable to the Commissioner. The following provides a summary of the essential highlights from CS – 17/01 for the different types of companies that might typically operate a share scheme.

Listed companies have the benefit of market prices. Privately held companies and start-up companies have a more tortuous path of trying to assess the value of their underlying shares, which for many is both an infrequent and subjective process which may necessitate the involvement of valuation professionals.

These challenges can be accentuated by the expanding complexity of valuations given the current volatile environment, and the need to consider long run, but material, value drivers like climate change and other ESG factors.

Listed companies

For a listed company with shares on a "recognised exchange" the Commissioner will accept the share value reached using one of the following methods:

- **Option A:** Volume weighted average price ("VWAP") over the last five trading days (including the acquisition date); or
- **Option B:** Closing Price on the acquisition date; or
- **Option C:** If the employee disposes of the shares on the acquisition date at market value on a recognised exchange, the actual proceeds is the share value reached. If the sale is in foreign currency the close of the New Zealand dollar spot price exchange on the acquisition date will be applied.

Privately held companies

For unlisted companies that issue shares to an employee (excluding start-up companies). The Commissioner will accept the share value reached using one of the following methods:

- **Option A:** The value concluded by an independent, suitably qualified valuer which confirms with generally accepted practice; or
- **Option B:** A valuation using the company's most recent transaction with another non-associated third party (within 6 months prior to the acquisition date or 12 months if the company is a start-up) involving the issue or sale of the same class of shares (for example, a previous capital raise or sale of a parcel of shares) where, if new shares are being issued to employees the valuation is adjusted for dilution of existing shares; or
- **Option C:** A valuation method prepared by an appropriate person in the company using an appropriate method (Discounted cash flow, or Capitalisation of earnings) for the market value of shares on the acquisition date. A copy of the valuation and supporting documents must be retained.
  - Under option C the valuation must also be approved in writing by one of the following:
    - A Board of Director member;
    - The Chief Executive Officer;
    - The Chief Financial Officer.

Valuation requirements

Start-up companies present some unique challenges, owing to the subjective nature of valuation assessments.

The valuation requirements for start-up companies are substantially the same as for privately held companies. However, entrepreneurial companies at an early stage of their development face some unique challenges, including:

- High levels of uncertainty as to the business model;
- Difficulty in accurately forecasting beyond a short time period with any certainty (which limits the reliable application of traditional valuation approaches);
- On occasions, shareholder claims as to value in information memorandums which ultimately prove to be optimistic or not market tested, but which may provide the only benchmark for value at the time of vesting shares;
- Higher volatility in the market value for shares;
- Lack of liquidity for employee shareholders to realise shares in order to meet tax obligations. On occasions employee shareholders can be left with tax liabilities in excess of the value of the shares.

Shares have long been a form of remuneration for start-up companies, and often one of the reasons they are able to attract talent. In our view the current tax setting provides a 'head wind' for New Zealand start-up companies that may be seeking to grow in this country. Practically, these companies need to think carefully about aligning any vesting to liquidity events to ensure that shareholders are not left with a tax obligation that is larger than the value of the shares held.

Conceptually, the valuation requirements for start-ups are the same as privately held companies albeit a recent transaction within 12 months prior to the acquisition date is accepted over 6 months.

Listed company snapshot

Performance share rights* dominate the landscape for listed companies looking to incentivise management. In our view, this is primarily because of the alignment with the current tax settings for employee share schemes. Variable performance based remuneration continues to be an important part of the remuneration framework for listed companies, perhaps because there is a clear reference point for establishing value and because there is liquidity for employees.

Parameters for analysis

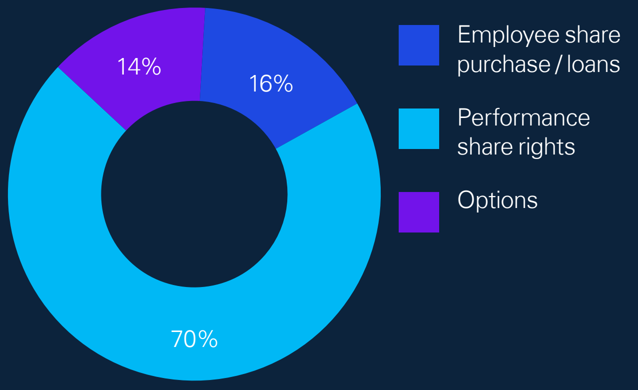
– NZX50

– Public disclosures in annual report

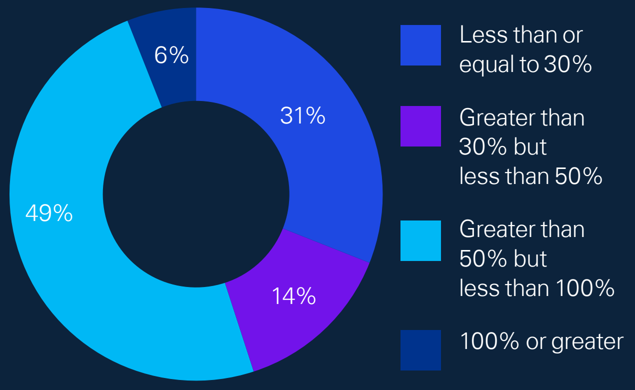
– Calendar year 2021

*Performance share rights (PSR): a zero strike option with vesting conditional on achieving certain performance thresholds.

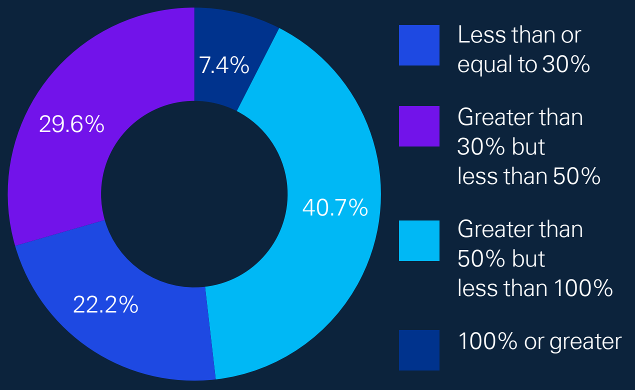
Type of Share Schemes (2021)



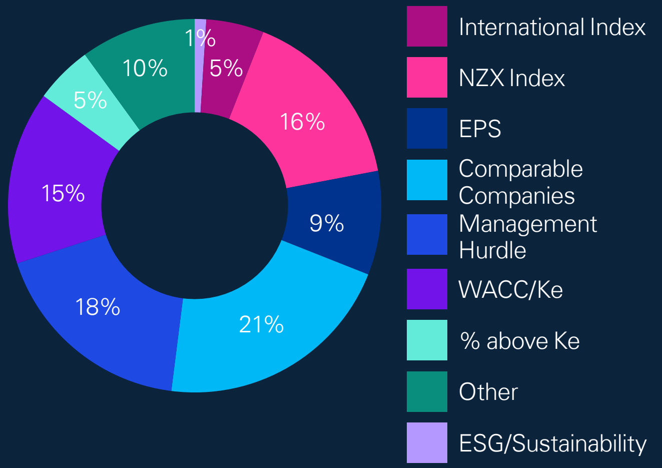
STI max proportion of FAR* - CEO



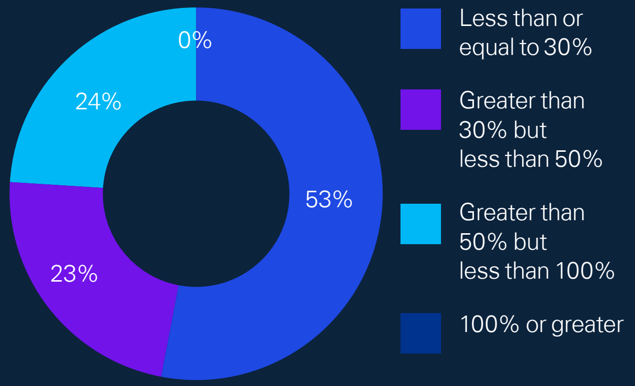
LTI max proportion of FAR - CEO



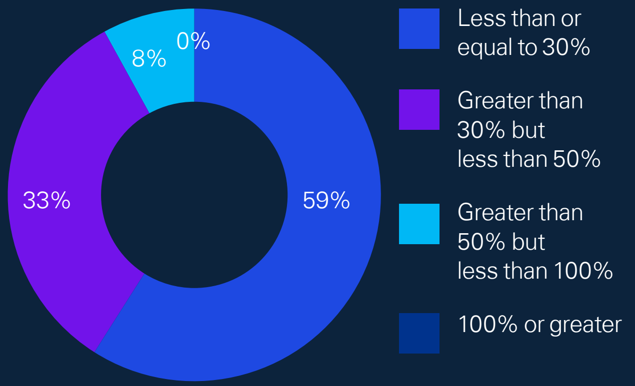
LTI Performance Hurdles Used



STI max proportion of FAR - Executives



LTI max proportion of FAR - Executives



*FAR: Fixed Annual Remuneration

Design considerations

There are a number of considerations for companies to evaluate when establishing or re-designing a share scheme, particularly for listed companies who will now be required to disclose (first disclosures from December 2023) whether, and if so how, their remuneration framework links to metrics and targets used for managing climate-related risks and opportunities.

The following provides a summary of key items which company remuneration committees and shareholders (in the case of privately held companies) need to consider when establishing or reviewing the design of a share scheme.

Ensuring that the performance metrics create the right incentives for management, and are clear and transparent, is central to getting the right outcome for the company.

Decisions made on the design of the instrument and the mechanism for payment (i.e. cash versus the receipt of shares) can also have significant implications for the accounting, tax outcomes and financial reporting of the benefit conferred to employees. Well designed schemes typically involve liaising with a range of professionals at the outset (per the following).

Professional involvement

Remuneration
Design phase

- Benchmarking remuneration packages and split between base, STI and LTI.
- Review of scheme complexity
- Alignment of management incentives with shareholders and stakeholders

Legal
Design phase

- Drafting scheme documentation
- Structure offering to comply with relevant securities law restrictions
- Negotiation of clauses, balancing risk and fairness between employees and the company

Tax
Design phase

- Initial review to ensure no unexpected tax consequences
- Review of legal drafting by tax and valuation professionals

Implementation

- Tax advice on implementation of scheme

Accounting
Design phase

- Review to ensure no unexpected accounting consequences

Implementation

- Financial reporting support, accounting opinions

Valuation
Design phase

- Review quantum of value being provided under the Scheme.

Implementation

- Valuation of underlying shares and benefits for financial reporting purposes

Sustainability
Design phase

- Review of climate and ESG metrics to be included within the scheme

Implementation

- Assistance with measurement and review of climate related metrics specific to company and industry strategy.

The following items would generally need to be articulated as part of any Scheme design:

- Description of instrument
- Process for setting the target share price(s) or earnings target
- Progressive vesting scale
- Vesting period
- Calculation of actual share price at the vesting date
- Offer date price
- Participating executives
- Responsibility for tax payments
- Settlement of performance share rights (PSRs) that have met the performance hurdles at vesting
- Determination of the number of PSRs to be issued
- Frequency of issue
- Capital events
- Timing for grant of PSRs and vesting dates
- Drag along and tag along rights
- Good leaver and bad leaver provisions

ESG and climate change – Linking remuneration to organisational metrics and targets

ESG and climate change

Over the last two years we have seen a significant increase in interest in ESG performance, specifically tied to climate change. This is not just happening overseas, ESG is becoming a common talking point in governance circles in New Zealand with initiatives such as Chapter Zero, being run by the Institute of Directors. Incorporating these performance metrics into remuneration and share schemes is being used to drive performance and decision making within organisations.

The XRB's Climate Standard is also likely to be a key driver with its requirement that companies disclose "whether and if so how" performance metrics are incorporated into remuneration policies. (CS-1, para [22h])

But this is about more than just disclosure. Appropriately structured incentive schemes can be a powerful force for driving outcomes.

Why link remuneration to the achievement of climate metrics?

Climate change is everyone's responsibility. Linking remuneration to the achievement of climate metrics moves the conversation from 'them' to 'I', where each individual is directly accountable for their impact. It is also important to align management incentives to the long-term prosperity of the organisation.

The board should explore ways it can transition management remuneration to meet long-term goals of the organisation, one way to do this is to consider climate-related targets and indicators in their management incentive schemes.

Good practice suggests that 'interim targets' can bridge the gap from today to longer-term strategic goals, and provide greater accountability to responsible executives. In our view, bridging these targets also maps better to the time frame of many employee share schemes

So where are we now?

In New Zealand we are at an early stage of making disclosures on the linkages between remuneration and climate targets. A recent review of the NZX50 disclosures for the 2022 year suggested only a handful of companies are disclosing links between their STI and LTI parts of remuneration and ESG / Climate change metrics, with most links focused on the short term (STI) as opposed to the long term (LTI) incentives.

With the introduction of the new XRB requirements, it is reasonable to expect that these linkages may become a frequent topic during questions times at Annual General Meetings. Relying solely on earnings targets or total shareholder return targets may be seen as being too limited in the years to come.

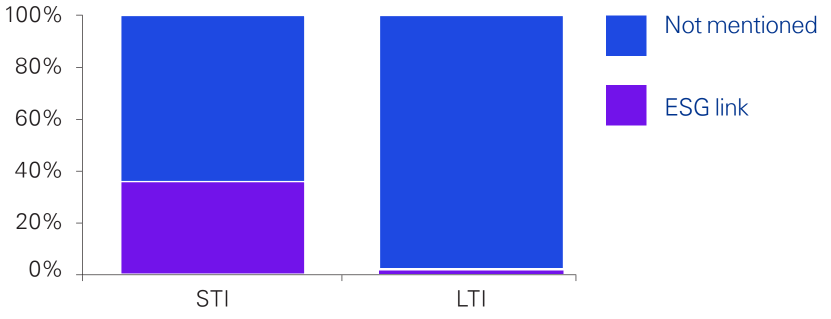
Be ready to explain how metrics and performance measures align to long term outcomes, such as achieving net zero and growing shareholder value. International experience suggests that it does take time to get this right.

Where do you start?

Three things for you to consider:

1. Start the process of linking climate metrics and targets to the broader business outcomes you are seeking and articulating how this impacts the value of the company – build that conceptual framework.
2. Making changes to remuneration structures takes time and requires consultation – you need to start now. Key questions may include how much remuneration will be tagged to climate metrics, will it be short term or long term focused (typically 3-5 years)? Will it be binary in outcome or graduated to reflect the achievement of a baseline performance versus a stretch target? Executive and management teams need to be on the journey.
3. Be ready to explain and disclose – while the first reporting under the new XRB standards won't be publicly available until after 1 January 2024, don't assume that the questions won't come earlier.

ESG performance links in NZX50 companies



In New Zealand we are at an early stage of making disclosures on the linkages between remuneration and climate targets.

ESG and climate change – NZX v ASX

ESG links in ASX50 company performance schemes

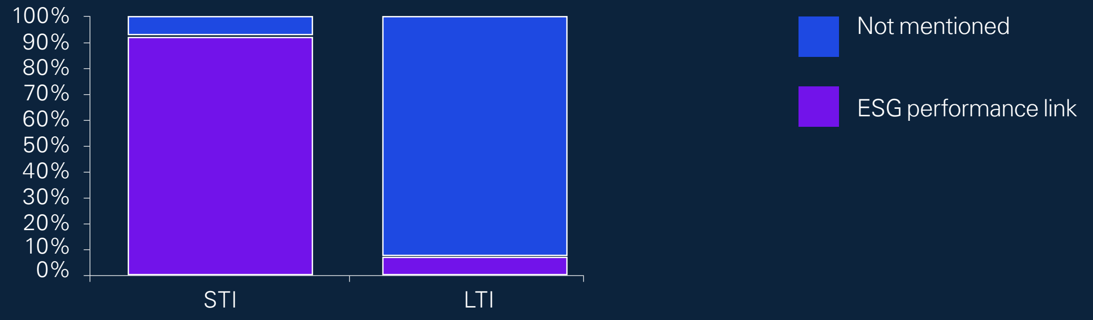
A review of ASX50 company disclosures for the most recently reported financial year, indicates the majority of ASX50 companies are disclosing ESG links for STI schemes while less than ten percent have ESG links in LTI schemes.

The ESG links in the ASX50 companies are often incorporated as a sub-criteria of 'non-financial' performance criteria and many had more than one ESG criteria. The most common ESG links were aligned to the Social or Governance pillar of ESG. A similar trend was also observed for the NZX50. This is presented in the graph opposite.

Unlisted companies need to consider this too

While the focus of the Climate Standard is initially on listed companies, unlisted companies also need to be thinking about how their employees are remunerated. As large listed companies look to investigate and report on their scope three emissions and ESG performance of suppliers, large privately held companies might well start to expect questions on how they are managing emissions and incentivising management.

ESG performance links in ASX50 companies



Most common disclosed ESG performance criteria

Note: The above graph only presents companies which have disclosed an ESG metric and some may have disclosed multiple ESG criteria, hence the percentage is lower than the total percentage.

Source: KPMG analysis annual reports ASX50 for the most recent financial year.

What to consider when setting ESG metrics?

Setting ESG performance metrics and targets

If New Zealand organisations are to link remuneration to the success of strategic sustainability initiatives of the business, there are certain considerations that could prove to be more effective than others.

Carbon emissions reduction

Organisations should set science-based emissions reduction targets. A long-term target can be broken down into interim targets/'goalposts' to ensure progress is tracking towards the long term target. Remuneration can be based on that individual's remit over a portion of an organisation's emissions budget. Consideration should be given to absolute and intensity-based emissions reduction targets.

Double materiality

Double materiality describes the impacts of climate change on the business (e.g. asset impairment risk from flood damage, or reduced crop yields) and impacts of the business on the environment (e.g. increased carbon emissions or degradation of native ecosystems). Remuneration should be linked to material risks and opportunities related to the business – this drives progress towards achievement of an organisation's core strategic priorities.

Data collection

Setting metrics and targets requires data connections and flows that ensure data is collected effectively to measure progress. Having data collection mechanisms in place that measure the right things at the right time will ensure a smoother transition to measuring KPIs relating to ESG.

What is the future of remuneration?

The range of ESG metrics and targets that businesses now track has increased radically over the past few years. With New Zealand Climate Standards (NZ CS) coming into force for Climate Reporting Entities (CREs) from financial years starting after 1 January 2023, Metrics and targets that organisations will measure and report on are likely to become even more varied.

There has already been a rise in external stakeholder activism and due diligence on the companies these stakeholders invest in or do business with. As such, deeper questioning of a company's remuneration practices to demonstrate commitment to climate related targets is becoming increasingly common.

To add to this, companies are starting to look to regulation on the horizon. Such possibilities include nature-related considerations, from the Taskforce for Nature-related Financial Disclosures (TNFD). Additionally, New Zealand is looking to follow in Australia's tracks in early 2023, requiring companies to fully disclose modern slavery risks within their supply chains.

Consider this: In early 2024, your Board meets to review your Employee Remuneration Policy for staff in Management roles. There is significant market pressure to respond to New Zealand's recent Biodiversity-related Disclosures, and Modern Slavery Disclosures. Company share prices have been positively correlated with ambitious commitments in this space. You look to set KPIs to environmental restoration and avoidance of human capital exploitation across your supply chain. The market responds positively and analysts upgrade their recommendation to 'buy' – you're the first in your sector to think this way.

Pursuing climate change and ESG programmes of work builds resilience and protects/enhances long term value. There is expanding anecdotal evidence that such initiatives will grow the number and quality of buyer/investor pools, which can only be positive to value. Said differently the cost of doing nothing is significantly greater.

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