SENATE ECONOMICS REFERENCES COMMITEE

EMPLOYEE SHARE PLANS

The Australian and International Experience

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SUMMARY OF SUBMISSION

ESP Structure and Operation

- The qualifying deferred provisions of Division 13A ITAA 36 were already sub-optimal, inflexible and suited only to stock exchange listed companies with short-term, speculative and sometimes excessive allocations to executive participants of large ASX listed companies.

- The proposed new provisions have merely exacerbated that situation.

The Benefits of ESP's

- ESP's have become a vital part of attracting, retaining and motivating labour at all levels of organisations. The benefits of ESP's are as follows:

  - Attracting the right employees for the right jobs.
  - Retaining employees.
  - Developing and Training employees as key assets.
  - Aligning employees' vision with shareholders' vision.
  - Motivating employees to achieve organisational performance objectives.
  - Recognising and Rewarding human capital as a valuable asset.
  - Succession Planning for management and/or employee buyout.
  - Reducing business cash outflows.
  - Maximising business capital investment and creating more jobs in sustainable, high performance enterprises.
  - Creating More Surplus Value and Sharing Surplus Value with employees.

Tax Compliance

- RSG welcomes the new tax compliance and reporting measures.

- These issues were raised by industry as far back as 1995 and nothing was done by the various Governments, Treasury and the ATO until 2008.

- RSG seeks and obtains ATO rulings on all its implementations.

Governments Announcement of Changes to Tax Treatment of ESP's.

- As far as we are aware, there was no consultation with peak bodies, practitioners and companies leading up to the Treasurer's 12 May Budget Announcement.

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- There appears to have been no industry consultation with interested and affected parties. Companies, who were in the process of making offers, or who had made offers, to employees in good faith on basis of legislation which has been in place for an uninterrupted period of thirteen years were left embarrassed and had their human resource management strategies compromised. This has had a negative impact on their employee and workplace relations. Many companies have put their existing plans 'on hold', and are currently reviewing alternative arrangements.

- Further to the Treasurer's 12 May Budget Announcement and the Consultation Paper released on 5 June 2009, Assistant Treasurer, on 1 July 2009 Senator Nick Sherry released a further Policy Statement setting out the Government's "final" policy on the taxation of employee share plans as of 1 July 2009. The "final" policy is as follows:

  (a) raising the adjusted taxable income threshold for the $1,000 tax exemption up to $180,000 per annum;

  (b) introducing a new qualifying salary sacrifice share plan, capped at discounts of $5,000 per annum;

  (c) introducing a limited deferral of the taxing point for discounts on shares and options, where there is a 'genuine risk of forfeiture' and restrictions on disposal for up to seven (7) years;

  (d) amending the basis for employee refund of income tax paid upfront for only certain forfeited equity benefits;

  (e) introducing annual reporting requirements for the above plans; and

  (f) confirming the application of the new proposals from 1 July 2009.

- Unfortunately, these changes will continue to cause some allocations from 1 July 2009 from qualifying deferred employee share and option plans to create upfront or premature tax liabilities for employees, preventing employees from taking up offers and leading to the depletion of employee share plan assets.

- However, on the positive side, unlike the former provisions of Division 13A (ITAA 36), benefits under the three qualifying plans mentioned above (refer points (a), (b) and (c)) can be provided <u>conjointly</u> in the <u>same</u> tax year.

- The impact on employees, employers and Australian business has been to cease operations of ESP's. This has been to the detriment of the Australian economy, especially for start up, R&D and investment companies.

- The capping of salary sacrifice at $5,000, the requirement to impose design conditions for tax purposes (i.e. "genuine" forfeiture conditions) and the restriction on the refund of tax on forfeited or lost benefits represents excessive Government intrusion into the optimisation of the design of employee equity participation plans.

- Generally speaking, employees can only afford to pay tax on their equity benefits when they sell their equity. Earlier taxation triggers can only act to deter employees from participating in ESP's, force premature disposal of shares and depletion of plan equity.

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- The optimal employee taxation regime for ESP's is to:

  - tax employees only when shares are sold;

  - subject the original value of the share to ordinary income tax (i.e. max tax of 46.5%); and

  - subject the growth in the value of the share to CGT (i.e. max tax of 23.25% if held for more than 12 months).

The Rules Governing ESP's in Other Countries

- The tax and regulatory regimes, in the leading, comparative, Advanced Western Economies (e.g. the UK and USA) are much more favourable for employees than Australia, especially in regard to concessional capital gains tax applying to the disposal of equity retained by participants for extended periods.

- While the Australian tax system tends to penalise employees for prolonged share retention, comparative overseas tax systems tend to reward share retention by employees with CGT concessions (i.e. by tax exemption and/or ratal reductions).

Other Related Matters

Currently, there is a lack of coherent Government and Departmental policy formulation in regards to tax, corporations law and valuation issues.

- Employee share plans are a complex area that straddle a broad range of tax, corporate legal, human/industrial relations, investment and remuneration issues.

- The development of accurate, and internationally accepted equity valuation principles, under accounting standard AASB2, has greatly assisted the equity valuation issues and enabled the development of accurate reasonable allocation levels, integrated into the organisations' base, short term incentive and long term incentive strategies.

- Unlisted organisations face vastly different issues to those facing stock exchange listed companies. They have no organised external market and usually target an IPO and/or other "monetisation event".

- There needs to be a designated Ministerial ESP portfolio, overseeing a specialist section in Treasury, which co-ordinates all issues concerning ESP's on an inter-departmental basis.

- Under the previous Government, the Department of Treasury held regular industry liaison meetings in their offices in Canberra for ESP practitioners and interested parties, whose input was vital for the development of effective, consistent and coherent ESP policies. These industry liaison meetings were ceased leading up to the last Federal Election and have never been reinstated. The Treasurer then made the ill-fated Budget ESP Announcement on 12 May 2009, which has been largely reversed in a piecemeal and unsatisfactory process. These meetings must be reinstated, the ongoing industry consultative process resumed and the appropriate ESP policies developed.

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A. THE STRUCTURE AND OPERATION OF EMPLOYEE SHARE PLANS

How Australian businesses choose a suitable ESP

In this section we will provide an outline of the range of ESP arrangements currently available in Australia and how choose which plan(s) are most suitable for various businesses.

Many companies have a pretty good idea of what kind of ESP they want to use, usually based on specific needs and goals. However, sometimes they might be better served with another kind of plan or a combination of plans. And yet others say they'd like to have an ESP, but they are not sure what it might be.

The challenge is to optimise the portfolio of ESP's

There are a broad range of plans to choose from. Quite often it is appropriate to have more than one plan. For example, there may be a broad based offering of ESP's involving. qualifying 13A Exempt and Deferred Plans, or a Broad Based Loan Participation Plan or Loan Share Plan.

These plans may have little or no downside risk and are designed to maximise employee participation. They are able to be designed to encourage retention i.e. shares vest and only become available after a certain period of service or they may only vest if a certain performance criteria being met or a combination of both.

Share Plan Options could be designed for senior management which more closely align their success to those of the shareholders and can be designed on achievement of a stipulated total shareholder return as well as achievement of other individual key performance indicators.

Where an employer does not have available shares – e.g. a joint venture or a franchise company, then it may be appropriate to provide a combination of Employee Loan Participation Plan i.e. facilitating investments in other than employers shares and/or a Replicator Plan.

Many of Australia's largest companies are subsidiaries of overseas based companies, sometimes listed on different overseas exchanges.

The Loan Participation Plan facilitates through a trust arrangement, the ability to acquire shares on market on those foreign exchanges or from new issues of shares which may have vesting conditions attached, or may be acquired as part of a salary sacrifice/bonus sacrifice equity based remuneration strategies.

Other plans may be designed to encourage senior executives to use salary sacrifice and bonus sacrifice sums to acquire shares in their own company or in an approved list of investments.

There are many combinations to suit the specific purposes of every type of business and any level and type of employee/contractor.

Choosing the Best Plan: A Roadmap

The term ESP covers a broad range of arrangements in a variety of organisations. When considering the optimal plan for an organisation, one should match the purpose of the plan in

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the context of the circumstances of the organisation, and the objectives of implementing an employee share plan.

The plans have been designed for universal application. That is, the intention in the design of the plans is that any employer organisation (that is, incorporated, unincorporated, listed, unlisted, government or private) operating in Australia will be able to utilise a plan and implement an employee share plan for all their employees.

Special consideration has been given to designing plans for those organisations for which implementing employee share plans were believed previously to be too difficult or inappropriate.

For example, for those organisations without available shares (for example, closely held family companies, government corporations, unit trusts, and co-operatives) so-called "replicator" plans and loan participation plans (that is, enabling investment in non-share securities) have been provided.

While certain plans have been designed with specific types of organisations in mind, for example:

- qualifying share plans for ASX listed companies; and
- replicator plans for unlisted or non profit organisations,

A listed ASX company may find that the non-qualifying loan participation plan and replicator plans are suitable for their employees. This is especially relevant, given the recent changes to the accounting standards, which will apply to all Australian companies, which require full disclosure and expensing of employee share benefits. Such changes will have the effect of creating a more neutral, "level playing field" between the different plans.

Prerequisites for ESP's

In order to create the necessary structure for effective delivery of equity benefits, it is important to recognise the important pre-requisites of an ESP. These are:

- Determination of the type of equity (e.g. shares, options or participation units);
- Valuation of the equity;
- Allocation of the equity; and
- Utilisation of a plan trustee for the implementations, administration, and marketing of the employees' equity.

Employee equity can be provided under a number of methods and structures. These may involve such things as option contracts or unit trust structures, which are appropriate for the circumstances of the particular employer organisation and its employees.

It is important that employees are secure in the knowledge that their participation delivers a fair share in the capital growth and profitability of the company, without jeopardising their fixed pay entitlements, nor exposing them or their families to unnecessary downside risk of the value of shares, being the subject of the options, happens to fall.

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Also the taxation outcomes of the ESP's chosen should be confirmed by an appropriate Ruling from the Australian Taxation Office.

The broad range of plans include:

- Qualifying Exempt Plans;
- Qualifying Deferred Plan;
- Non-Qualifying Employee Loan Plans; and
- Non-Qualifying Replicator Plans.

These plans can be broken down further into:

- Qualifying Exempt Plan
    - Exempt Share Plan
    - Exempt Option Plan
- Qualifying Deferred Plan
    - Deferred Share Plan
    - Deferred Option Plan
- Non-Qualifying Employee Plans
    - Loan Share Plan
    - Loan Participation Plan
    - Employee Option Plans
    - Geared Employee Share Trust
- Non-Qualifying Replicator Plans
    - Unfunded Replicator Plan
    - Funded Replicator Plan

While not all of these plans will enable employees to become long-term holders of shares in their employer, all of the plans will enable employees to share in the growth and prosperity arising from their work with their employer.

Employee Equity

The employee equity can be provided under a number of methods and structures. These may involve such things as option contracts or share trust structures, which are appropriate for the circumstances of the employer organisation and its employees.

Until the late 1980s, employee share plans were typified by loan plans and partly paid share plans, and supplemented in the executive arena by the provision of executive options.

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Since the late 1980s, due to a number of factors including changes to the superannuation requirements restricting the ability of superannuation plans to invest back into shares of the employer, a series of corporate crashes, a recession on the Australian share markets and the adoption of New Pay strategies highlighting the need to more directly integrate employee share plan strategies with employee strategic remuneration, there was a steady move away from loan plans and partly paid plans.

Loan plans and the partly-paid plans (for example, shares issued, called and paid to one cent) were seen as inflexible, separate from the remuneration strategies of the organisation and difficult to impose performance-based vesting conditions upon.

Options were popular at the executive levels, but had little acceptance or relevance at the lower ends of the corporate hierarchy.

Employee Share Option Plans

Increasingly, employees and non-employee contractors are asked by the company offering them a job, to receive a substantial part of their remuneration in the form of share options in the company. These options may have a life of 5 to 10 years and are usually subject to vesting conditions or a non-exercise period extending 2 to 5 years. They may also be subject to other conditions such as performance hurdles or a growth in shareholder value (i.e. by issuing options with a premium exercise price).

Options as a substantial part of professional remuneration packages are becoming increasingly popular, especially for start-up companies in their early growth phases. In industries such as the mining industry, options fulfil an indispensable role as a means of attracting, retaining and motivating key staff.

However, those participating in option allocation programs need to be confident that the options are valued properly, administered correctly and can be exercised into marketable shares or the cash equivalent at some time in the future.

The valuation of options has become more reliable and consistent since 1 January 2005 because of new accounting rules, which have been introduced recently in Australian and most other advanced western economies (refer AASB2 issued by the Australian Accounting Standards Board).

Restricted Shares, Performance Rights and Zepo’s

Restricted shares, Performance Rights and Zepo’s (zero exercise priced options) provide the employee with the benefits of a whole share, which includes the acquisition price of the share plus any growth of the share that has occurred over the holding and vesting period. We shall refer to these arrangements as full value equity (FVE’s).

Exactly the same vesting and performance conditions can be applied to FVE’s as applied to classical, growth-only options. FVE’s provide a more effective and efficient provision of share benefits, because employees receive the benefit of the whole share. This means that less share capital is required to provide benefits to employees under an FVE plan than a classical, growth-only, option plan. Furthermore, an FVE plan preserves the efficacy of the employer's long-term incentive structure as share benefits can be provided effectively in “crab” and “bear” market conditions, under which the shares may be experiencing nil or minimal capital growth.

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Recently, some company's have broken up the long term incentive based FVE into two components. Those components are:

- Are the employee retention component which is delivered by way of FVE; and
- An incentive component that is delivered by classical, growth-only options.

Earmarking Equity for Staff

Companies often earmark or set aside a percentage of the issued share capital in the company to be provided in the form of share options. This percentage may range from 5% to 20%, depending on the size and type of company, its maturity, its business circumstances and the remuneration strategies of the company.

Plans for Unlisted Companies

For unlisted companies, there are 4 main methods of providing both real and notional equity to the employees:

- $1,000 per annum worth of qualifying tax exempt shares or share options;
- a replicator plan which does not utilise shares at all, but communicates formula-based performance rights and is ultimately paid out as ordinary salary and wages;
- a special purpose employee share trust, which allows selected employees to invest in shares or other securities of the employer and ultimately acquire those investments funded by an interest-free, non-recourse, loan facility; and
- a special purpose Employee Option Plan, which allows selected employees to acquire options to shares of the employer, or receive the equivalent in cash.

The 5 requirements for an employee share plan, utilising unlisted shares are as follows.

- The plan must involve available shares or their substitutes (for example, shares, units, rights, options or other entitlements).
- There must be an acceptable valuation basis for the shares (for example, multiples of earnings before interest and tax or net asset values).
- There must be a reliable warehouse for shares, investments to ensure shares are retained within the plan (for example, a share trust, share company or option contracts).
- There must be an effective market for shares (that is, usually an employee share trust funded by the employer and participating employees).
- There cannot be any obstacle to employee participation (for example, no drain on employees' personal cash resources, controlled downside risk exposure no tax upfront and deferred tax until disposal of entitlements).

Plans for Listed Companies

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Listed Companies can also provide these plans to their employees but also in addition to the Qualifying Tax Exempt Plans, Listed Companies are able to offer Qualifying Deferred Plans. However, the application of Qualifying Deferred Plans (e.g. as restricted share or option plans) will become limited to delivery of Executive Long-Term Incentives, which readily incorporate "real" risk of forfeiture (now required under the proposed Division 83A ITAA 1997) and which are short term and will encourage more short term risk taking by participants.

Consequently, there will be a trend for listed companies to adopt long term incentive based employee equity strategies outside of the provisions of the proposed Division 83A ITAA 97.

Government support for employee share plans

The Federal Government in February 2004 announced its policy intention to develop a program to encourage equity participation in Australian businesses – with the aim of doubling the current level of employee equity participation from 5.5% to 11% over a 5-year period. As a part of that process, RSG was awarded the tender to design a range of employee share plans which could be used in a wide range of Australian businesses.

The Government believes that it is in the public interest to promote employee share plans to:

- better align the interests of employees and employers;
- to develop national savings;
- to facilitate the development of sunrise enterprises;
- to facilitate employee buyouts and succession planning; and
- to develop internationally competitive, best practice, remuneration strategies for employees of all organisations.

The Federal Government, by way of the Department of Employment and Workplace Relations (DEWR), accepted RSG's recommendation that, in order to achieve its target levels of equity participation, it needed to encourage equity participation in all its forms (that is, real and replicated), for application in all types of Australian employer organisations, for all categories of employees.

All the ESP's outlined in the RSG ESP Framework have been implemented in Case Study organisations nominated by DEWR.

The RSG Road Map and RSG ESP Framework outlined below resulted from this project.

ESP Roadmap

Set out below is the RSG Employee Share Plan Roadmap (see diagram on following page) to assist an organisation with charting the course of best plan selection for the circumstances of the organisation. To chart the roadmap, you simply begin from the top left hand corner and chart the flow of the roadmap according to the Yes or No answers to the factual circumstances presented. You should end up with the plan or plans that suit the particular circumstances of the organisation.

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The following plan outlines includes successful design features that have been confirmed as a viable, working model capable of implementation in Australia based on international "best practice" and the actual experience of successful employee share plans implemented for Australian companies of all types and sizes.

The taxation consequences of the various plans are in accordance with private binding rulings obtained from the Australian Taxation Office.

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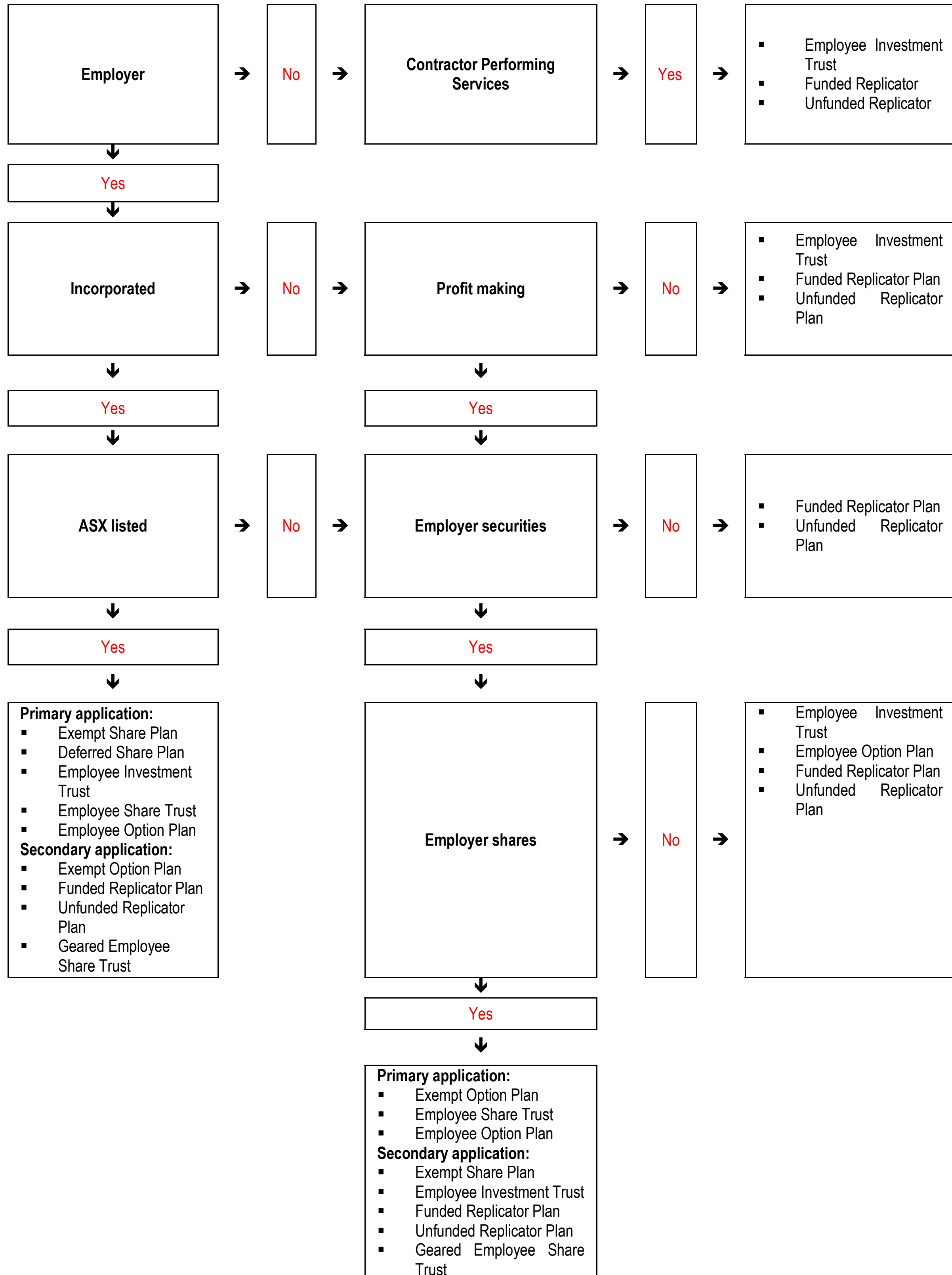
Employee Share Plan Decision Tree - "Roadmap"



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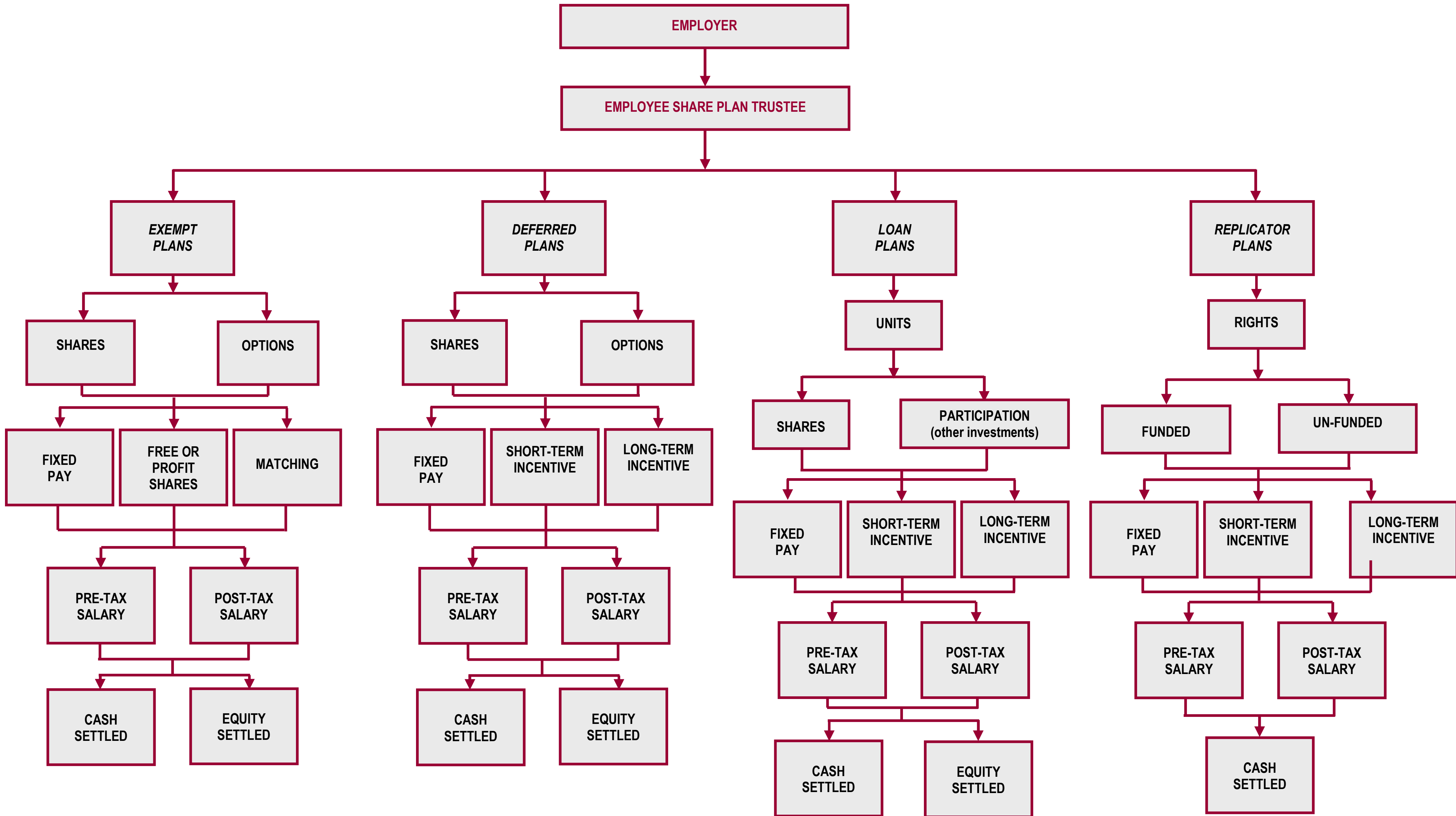
RSG ESP Framework



B. THE BENEFITS OF EMPLOYEE SHARE PLANS

The Benefits of Employee Share Plans

RSG is about developing and optimising the value of human capital as business assets of the organisation and personal assets of the employees of the organisation.

The value of human capital is optimised by:

- **Attracting** the right employees for the right jobs.
- **Retaining** employees.
- **Developing and Training** employees as key assets.
- **Aligning** employees' vision with shareholders' vision.
- **Motivating** employees to achieve organisational performance objectives.
- **Recognising and Rewarding** human capital as a valuable asset.
- **Succession Planning** for management and/or employee buyout.
- **Reducing** business cash outflows.
- **Maximising** business capital investment and creating more jobs.
- **Creating More Surplus Value and Sharing Surplus Value** with employees.

This is best achieved by ongoing employee training and development projects and by linking employees to the company by utilising the right kind of employee remuneration strategies and related employee equity programs.

There is a direct link between Employer Equity Programs, Human Capital Management and Companies Financial Performance.

International experience demonstrates that effective Employer Equity Plans assist in the attraction, motivation and retention of employees.

Furthermore, for employees that human capital value should be manifested into actual asset value emanating from effective short and long term equity based incentive programs, providing an enduring and valuable capital base to maintain their human capital investments.

It is RSG's experience, supported by extensive international studies, that the opimal methodology for the design, implementation and administration of effective employee LTI programs for <u>all</u> stakeholders is to base the LTI program on Employer Equity Plans. These programs are most effective where equity holdings are maintained and not dissipated by short term profit taking.

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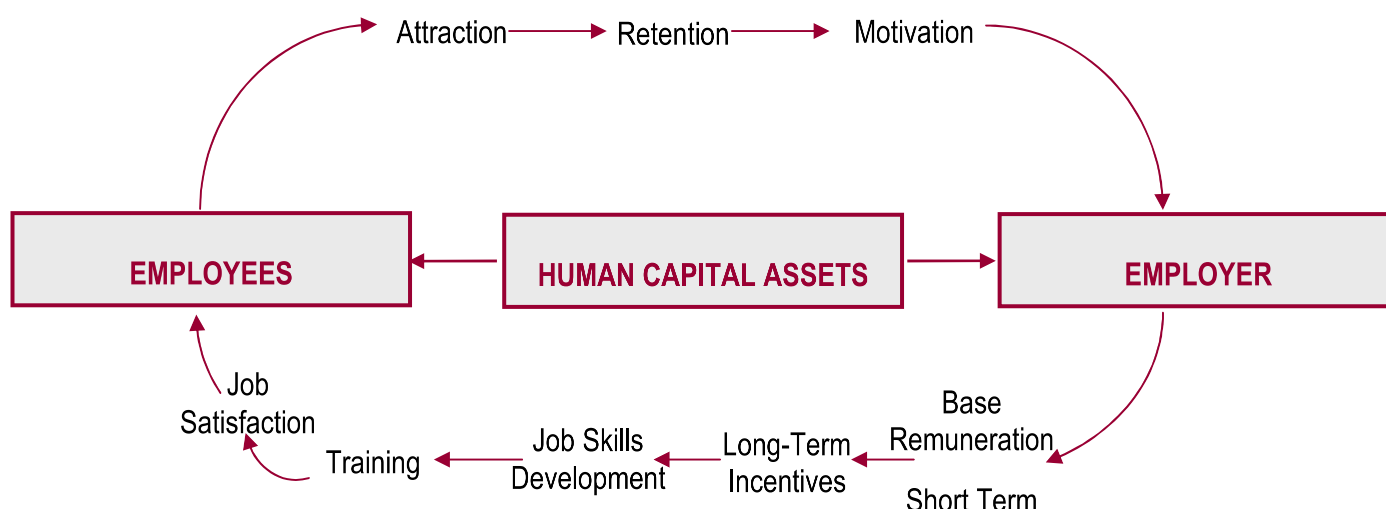
The Human Capital Dynamic



Long Term Incentives (LTI's)

LTI's assist in the retention of employees, which means the business can afford to spend more money on training. Additional training results in better qualified employees and a more productive and profitable business. And because employees are trained to develop job skills they feel more appreciated, more respected and have greater levels of job satisfaction which will ensure that they remain employed longer.

Retention

An Australian Human Resources Institute ("AHRI") survey has found Australian employers are losing an extra $20 billion per year as staff turnover increases dramatically.

- A dramatic increase in staff turnover figures across Australia is putting people management practices under pressure.
- An AHRI HR pulse survey has found most organisations have employee retention problems.
- An overwhelming majority reported an impact on the organisation's effectiveness and the bottom line.
- Most also believe their organisations are not prepared to deal with the labour crisis.

Staff turnover in Australia has increased by more than 5% as the continuing staffing crisis caused by the skills shortage and the ageing population puts people management practices under pressure.

A study last year by Vedior Asia Pacific put the cost of replacing an employee at closer to 150% of salary when recruiting, training, specialist knowledge and productivity are included in the cost.

AHRI's quarterly HR pulse survey, has recorded a turnover rate of 17.4% for large employers and an average of 18.5% across all organisations. The survey was carried out in conjunction with retention specialists, TalentDrain. Research last year confirmed the rate at 12.6% in large Australian companies (AIM National salary survey 2007).

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More than 60% of the people surveyed admitted they had a problem retaining staff and 80% reported an impact, cause by retention issues, or organisational effectiveness and financial performance.

An overwhelming majority of respondents to the HR pulse survey (82%), believed that their organisations were not prepared for the continuing skills shortage.

All Types of Businesses

LTI plans delivered through employee participation plans are no longer the exclusive preserve of senior management of large, publicly listed companies.

It is no secret that the skills shortage is crippling many industries. And so, tools and strategies that attract, and keep key staff are more crucial than ever. Employee Share Plans ("ESP's"), are one such tool. These are arrangements whereby business owners share the surplus value (profitability and capital value) of their enterprise with employees.

Businesses of all sizes and types can develop ESP's which generally aim to encourage employees to invest in the business they work in, and to more closely align employee performance with corporate financial and business objectives.

While ESP's might seem complex or costly to implement, the key message to businesses is that ESP's can be put in place for all types of organisations and all types of employees and/or contract non-employees working in Australia. And given the current skills crisis facing many industries, ESP's could be your answer to acquiring and retaining key employees.

The whole purpose behind employee ownership is that the employees have a share in the business, and it's considered that will give them greater incentive to perform. And as the business grows, they benefit.

Consequently, these plans offer potential benefits to employers such as helping to retain key employees, motivating staff, and improving productivity, efficiency and competitiveness.

Because employee retention improves, so too does the financial efficiency in investing in training and development, to improve the value of the business Human Capital Assets.

Optimum Remuneration

The optimum remuneration strategy has three elements: fixed remuneration (what you are paid to come to work), short-term variable remuneration (your profit share, incentives and bonuses) and long-term incentives (usually a share in the capital value of the organisation – an ESP).

Fixed remuneration or base pay, as it is also known, is commonly defined as the salary or the pay amount given to an employee for performing the daily duties of the defined job.

Short-term incentives – including annual incentives, bonuses, commissions and the like – reward the individual employee for achieving certain goals over a short period. The measurement period for short-term incentives is most often quarterly, semi-annually, or annually. Short-term incentives can be measured based on the individual's own performance, group or team performance, or the companies overall performance. This depends on the organisation, the incentive plan, and the level of the individual within the organisational hierarchy.

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LTI's delivered though ESP's – including shares, restricted shares, share options, phantom shares, share replicators, participating units, and the like – measure organisation-wide performance, typically over several years. The intent of such plans is to provide incentives for employees to improve the overall performance of the organisation by linking the employees' long-term rewards to the organisations long-term results.

ESP Plans

ESP plans reward participants (e.g. employees) for attaining results over a longer measurement period. For this purpose, long-term generally means more than 1 year, and typically is between two and five years.

The form of benefits and delivered from a long-term incentive plan is normally cash or equity. The reason an employer would choose one or the other depend on the goals of the plan, the type of recipients and the availability of cash or equity for delivery of those benefits.

Cash Based ESP's

Cash-based replicator plans allow organisations to target specific performance levels over a long term. Organisations using such plans need to exercise caution to avoid confusion and complication that may result from implementing a long-term cash incentive plan that looks like the organisations short-term incentive plan.

Cash-based plans have their place. They are effective in rewarding employees, teams, groups, departments and other entities for meeting or exceeding performance milestones that span more than 1 year. One of the benefits to the employer of using a cash-based plan is that the plan and its rewards can be very specifically tailored. For example, if the goal of the company is to increase market share for a particular product line from 10% to 33% over the next 39 months, the company can match a long-term incentive plan to that goal (presuming there is a reliable measure of market share for that product). Further, because the payments are made in cash and not equity, there is no need to introduce a second variable (e.g. share price) that complicates and confuses the linkage between the performance and reward. That is, the value of the awards can be pinpointed the day the program is in place because the currency does not change over time.

Cash-based plans are effective when:

- The target recipients are to be rewarded for performance that isn't precisely correlated with share performance.
- The share price is not tracking properly with the company's performance (e.g. the industry is out of favour).
- Shareholder dilution is a concern.
- Broad-based employee groups are targeted for ESP's and they have shown strong preference for cash rather than shares (Companies sometimes find it favourable to pay with cash rather than to pay with shares when they believe employees will sell any shares as soon as possible to convert them into cash).
- Employee retention is critical.

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Equity Based ESP's

Equity-based plans are the most common form of ESP; and share option plans and restricted shares are perhaps the single most common for of ESP in use.

Equity-based plans are effective when:

- The employer wants to create a strong link between the employee's performance and the company's performance.
- There is limited cash available for employee incentives. This is most prevalent among early-stage start-ups that are cash poor and therefore use equity for its high risk/high reward characteristics.
- It is desirable for employees to feel and act like owners.
- Retention is important.
- The employer has substantial growth (i.e. “blue sky“) potential.

Equity-based plans can take two forms; entire value, or appreciation only. The primary difference is that one form provides full value of the equity whereas the other measure only the increase in value of the same equity – typically measured from the equity's value on the day of the original grant. Neither form is better than the other, each has its strengths and weaknesses. Plans with awards based on appreciation only are perceived to be stronger when the goal is to reward for future performance – that is, to reward for the increase in value from today. Plans with awards based on entire value provide a broader continuum of payments, allowing awards to be paid if the share value drops below its current level. These plans provide more stability in payments and typically less volatility overall.

Linking Performance

For some time, executive remuneration has been a high profile issue. It seems that every day there is an article splashed across the business pages of the newspaper, expressing concern about the amounts of cash and equity being delivered to executives. A large part of the concern is that executives are seen to be rewarded independent of company performance. The perception is often that executives get rich at the expense of the shareholders.

In this environment, it is extremely important that executives' and employees' remuneration strategies have been closely linked to company performance and shareholder value creation. Choosing effective performance measures in long-term incentive programs will ensure that rewards are commensurate with performance, and that shareholders feel they are all being treated fairly.

Australian Experience

In the past, Australia has missed golden opportunities to develop and maintain effective employee ownership policies. Given looming demographic pressures, any future failure to promote commitment and productivity in the workplace will have a serious effect on this nation's prosperity and the distribution of that prosperity. Ordinary Australian workers must have the chance to become significant co-owners of the businesses in which they work.

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The Shared Endeavours report into employee share ownership was tabled in the House of Representatives in October 2000. In March 2003, the Federal Government responded, but then only to support limited measures. These included the establishment of an Employee Share Ownership Development Unit within the Department of Employment and Workplace Relations ("DEWR"). Subsequently, at the 2006-07 Budget, the Government extended the tax provisions governing employee share plans to ASX listed stapled securities.

What is Human Capital

Human capital management ("HCM") has been described as "a strategic approach to people management that focuses on the issues that are critical to an organisation's success" (Kingsmill, 2003) and "the possession of knowledge, applied experience, organisational technology, customer relationships and professional skills that provide a company with a competitive edge in the market" (Edvinsson, 1997).

Human capital is a component part of the "intellectual capital" of a company, which is linked to the difference between market value and book value of a company. "Recent estimates suggest that 50 to 90 percent of the value created by a firm comes, not from management of traditional physical assets, but from management of intellectual capital" (ICAEW, 1999).

The term "human capital" represents an asset with a flow of benefits that are greater than the cost of the asset. To most, the term human capital means assets that yield income, so that when using the term human capital, it means the value added by the workforce.

There is no question that it pays to manage people correctly and maximise the human capital assets of the organisation.

Organisations have long focussed resources on other aspects of their companies, including infrastructure, R&D, sales and advertising, just to name a few. These things can increase shareholder value creation in measurable ways. Some – but certainly not all – tried to optimise their human capital to increase returns to shareholders. But even these companies were taking a shot in the dark, because no one could quantify which human capital programs were linked to good outcomes. Some companies failed to maintain and develop their optimal human capital programmes.

It is now incontrovertible LTI's delivered through ESP's form an integral part of Human Capital Management.

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C. COMPLIANCE ISSUES

While most employees and employers have expressed concern about the nature of the Government's announced measures and the manner of in which they were announced, there is general support for measures to improve fairness and integrity in the taxation of employee share benefits.

Dating back to the industry lobbying which culminated in the enactment of the provisions of Division 13A ITAA 36, industry representative have recommended to the Government, the ATO and Treasury officials that they needed to establish some efficient regime for tracking employee share and option allocations under the qualifying exempt and deferred provisions of Division 13A ITAA 36.

At that time (i.e. 1995), the various Governments, the ATO and Treasury Officials disregarded those industry requests and suggestions.

For example, employees making a section 139E election, which was mandatory, for employees participating in the $1,000 per annum tax exempt plans, did not need to lodge the signed section 139E election form with their relevant income tax return or with the share plan administrator.

Irrespective of that regulatory lacuna, our EST administration company, Trinity Management Group has established a practice of employees making the section 139E election as a part of the plan's application form, which was approved in writing by the ATO. Under this process, the share plan administrator has a record of all section 139E elections made by employees participating in all the plans that it manages.

However, it was only in the recent Tax Laws Amendment (Budget Measures) Act 2008 (i.e. 58 of 2008), that the Department of Treasury and the ATO had the Government enact legislation which required employee to include the section 139E election and disclose the amount of the discount in respect of shares or rights in income tax returns of employees, beginning the year ended 30 June 2009.

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D. ANTICIPATED IMPACT

The immediate impact on these changes has been the freezing of most employee share plans at all levels of organisation, especially large listed organisations.

The actual impact has been heavily focussed on ASX listed companies, as this is where the bulk of employee share plan allocations are concentrated.

Other organisations have been less affected as they tend to incorporate loan based plans and replicator plans, which can continue unaffected by these proposed changes.

2009 Budget – Employee Share Plans

The Treasurer's 2009 Budget Announcement contained in Budget Paper No.2 which as of 7.30pm, Tuesday, 12 May 2008, had the effect of:

- Removing the tax deferral option for employee qualifying share discounts; and
- Limiting access to the upfront, $1,000 per annum, tax exemption to employees with adjusted taxable incomes of less than $60,000 per annum.

Consultation Paper 5 June 2009

In a Consultation Paper released on 5 June 2009, the Government amended the earlier proposal to tax employee share discounts upfront, subject to:

(a) raising the adjusted taxable income threshold for the $1,000 tax exemption up to $150,000;

(b) introducing a limited deferral of the taxing point for discounts, where there is a "genuine risk of forfeiture";

(c) limiting the refund of income tax paid upfront for forfeited benefits;

(d) introducing annual reporting requirements; and

(e) deferring the application of the new proposals until 1 July 2009.

Further to the Treasurer's 12 May Budget Announcement and the Consultation Paper released on 5 June 2009, Assistant Treasurer, on 1 July 2009, Senator Nick Sherry released a further Policy Statement setting out the Government's "final" policy on the taxation of employee share plans as of 1 July 2009. The "final" policy is as follows:

(a) raising the adjusted taxable income threshold for the $1,000 tax exemption up to $180,000 per annum;

(b) introducing a new qualifying salary sacrifice share plan, capped at discounts of $5,000 per annum;

(c) introducing a limited deferral of the taxing point for discounts on shares and options, where there is a "genuine risk of forfeiture" and restrictions on disposal for up to 7 years;

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(d) amending the basis for employee refund of income tax paid upfront for certain forfeited benefits;

(e) introducing annual reporting requirements for the above plans; and

(f) confirming the application of the new proposals from 1 July 2009.

Unfortunately, these changes will cause some existing qualifying deferred employee share and option plans to create upfront tax liabilities for employees.

However, on the positive side, it should be noted that, unlike the former provisions of Division 13A (TAA36), the three qualifying plans mentioned above (refer point (a), (b) and (c)) can be provided conjointly in the same tax year.

As from 1 July 2009, these changes will cause some forthcoming qualifying share and option plan allocations to create upfront tax liabilities for employees. Some employee option plan allocations from 1 July 2009 could be taxable to employees upon vesting.

Tax Upfront

One lesson we have learnt from our long standing professional engagement with employee share plan practice, is that generally speaking, if employees are offered shares and need to pay tax upfront, they will simply not be able to afford to take up the shares offered to them.

The Treasurer's announcements may affect certain allocations to Australian employees as from 1 July 2009 under the $1,000 tax exempt share plans, which are issued at a discount. However, the lifting of the annual adjusted taxable income, threshold, from $60,000 to $150,000 and now to $180,000 per annum (i.e. including taxable income reportable fringe benefits, reportable superannuation contributions and total net investment losses), should ameliorate most concerns with the Government's earlier proposal concerning exempt share plans.

On the positive side, under the new provisions applying from 1 July 2009, it is possible for an employee to participate in the qualifying $1,000 tax exempt plan, a qualifying salary sacrifice plan capped at discounts of $5,000 per annum conjointly and the tax deferred plans that meet the new stringent "genuine risk" of forfeiture conditions in the same year of tax. This has been confirmed by relevant Treasury officials in Canberra.

New Reporting Requirements

As mentioned earlier, there will be new ATO reporting requirements for all qualifying employee plans which will apply to all qualifying employee share issues from 1 July 2009 which must be provided to the relevant employees by 14 July and the ATO by 14 August following the end of the relevant financial year (i.e. 2010).

Industry Consultation

There appears to have been no industry consultation with interested and affected parties prior to the Treasurer's announcement. Companies, who were in the process of making offers, or who had made offers, to employees in good faith on basis of legislation which has been in place for an uninterrupted period of thirteen years were left embarrassed and had their human resource management strategies compromised. This has had a negative impact on their employee and workplace relations. Most companies have put their existing plans "on hold", and are currently reviewing alternative arrangements.

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The limitation of the $1,000 per annum tax exemption on share benefits would have had a particularly deleterious effect on companies' general employee share plan arrangements, effecting non-discriminatory offers, across the board, to all employees, reflecting its antecedents as the plan that made <u>all</u> Qantas employees shareholders in the then newly privatised enterprise.

The then Federal Labor Government policy, which privatised several former government enterprises, required those organisations to set aside a minimum of five percent (5%) of their issued capital for the benefit of all their employees (e.g. the Australian Industry Development Corporation, Commonwealth Bank of Australia, and Qantas).

Taxation Consequences

Ironically, qualifying ESP's which provide for a deferral for tax, will provide a substantially greater overall tax take, than ESP's which are taxable upfront (refer to our tabulated comparisons at pages 43 and 44).

Limiting Salary Sacrifice

With this in mind, the proposal to limit qualifying share discounts provided on a salary sacrifice basis to a capping of $5,000 per annum is unduly restrictive. It limits both the potential for employees to maximise their stakeholdings in the company, providing more jobs in that company and the capacity for the Government to maximise its taxation take from employee share plans over time.

Reduction of Tax Deferral from 10 to 7 Years

The proposal to limit the deferral period from 10 to 7 years is again restricting the effectiveness of employee share plans and unnecessary.

Studies completed by Vince Fitzgerald of the Allen Consulting Group in 1995 prior to the implementation of Division 13A, demonstrated that employees maintaining their shares in an employee share plan on average for a period of 7.4 years. Therefore, the limitation of the period of deferral for 7 years, or for that matter, 10 years is unnecessary.

Tax Refunds for Forfeited Benefits

The employee tax refund rules have been extended to cover forfeited shares as well as forfeited rights – which was a flaw in the provisions of section 139 DD of Division 13A, which was restricted to "lost" rights.

However, the proposal to exclude the refund provisions applying to situations which occur as:

(a) a choice of the employee; and

(b) related to the loss of market value of the shares or rights,

is unduly restrictive and will act as an obstacle for employees taking up equity in their employing company.

Taxation on Termination of Employment

Of course, the proposal to impose tax on all qualifying deferred benefits on the termination of employment is again short sighted and contrary to the prevailing views of many influential bodies, including the current Productivity Commission.

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Proposed Solution

We noted with some concern the Assistant Treasurer's proposed "solution", which appears as follows on page 8 of the Policy Statement:

"Where shares or rights vest after an employee ceases employment with a company, it is open for a company to offer a "partial vesting" arrangement to enable their employees to dispose of a proportion of shares or rights to pay tax crystallised on cessation of employment."

This is an effect a prepayment of income tax by the disposal of shares, prior to the share benefits "coming home" to the employees.

Under ordinary income tax principles, there would not crystallise any taxable benefit, until the benefit had come home to the employee.

Furthermore, had the employee paid the tax on the unvested shares at the time of termination of employment, and the shares never vested the employee would not obtain the shares, the shares would revert back to the employee share plan trustee to reallocate the shares to other current and/or future employees of the employer, who would again need to pay income tax on those share benefits.

If the employee could not obtain a refund of tax on the forfeited shares (i.e. because the employee chooses to forfeit due to loss in the market value of the shares), this would create an illogical situation of double (and possibly further multiple) taxation of unvested share benefits.

Alternatively, if the employee could obtain a refund of tax on the forfeited shares (e.g. because the vesting conditions were not achieved) the employee would be receiving up to 46.5% of the value of shares that he or she should have never been entitled to.

Either scenario creates an unsatisfactory and premature payment of tax and is indicative of a lack of systemic coherence and logic in the proposals.

Start Up R&D and Speculative-Type Companies

While the Board of Taxation is a respected body, established as a result of recommendations of the Ralph Committee Report, the reference to the Board of Taxation to consider whether Start-Up, R&D and Speculative-Type companies should be provided with additional deferral arrangements, while ignoring relevant peak organisations, professional practitioners and companies involved with these industries is unsatisfactory. Again, the Government appears to be continuing with a practice of not consulting with relevant peak organisations, practitioners and companies. The use of employee share and options as a vital part of attracting, retaining and motivating key qualified staff is a vital part of conducting these Start Up R&D and Speculative-Type companies.

Many of these Start Up R&D and Speculative-Type companies are cash poor. The capacity to provide shares and option in lieu of scarce cash resources, and provide employee with a share of the organisation tied to a so-called "monetisation event" (i.e. trade sale, takeover or an Initial Public Offer on a recognised stock exchange) is vital to the effective operation of these companies.

Again, these situations simply reinforce the truism for the taxation of employee share benefits, that they should be taxable to employees <u>only</u> when the equity is sold, the benefits are realised and employees have the cash resources to pay the tax.

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Once again, the studies show that by deferring the tax on employees' shares the Government's tax take will be maximised (refer Saving Through the Firm: Employee Share Plans – Context Role and Implications for Enterprise Performance Saving and Taxation by Dr. Vince Fitzgerald. The Allen Consulting Group [1993 and letter of 6 August 1999).

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E. ESP's IN OTHER COUNTRIES

Overview

There is currently, a large amount of international research in the area of ESOP's, the majority of which emanates from the US and, more recently, from the European Union ("EU"). The key difference between the US and EU research is that the implementation of ESOP's is relatively widespread in the US in comparison to the EU (and Australia). The widespread acceptance of ESOP's in the US has broadly been explained as a direct result of tax-incentives introduced in the 1970's and 1980's in the US. Many of these incentives continue to have effect today and encourage further acceptance of ESOP's by both employers and employees in the US.

United States of America

A Statistical Profile of Employee Ownership
Updated February 2008

Estimated Number of Plans and Employees; Value of Plan Assets

Type of Plan	Number of Plans (as at early 2008)	Number of Participants (as at early 2008)	Value of Plan Assets (as at early 2008)
ESOP's, stock bonus plans and profit sharing plans primarily invested in employer stock.	7,774	11.2 million	$928 billion +
Section 401 (k) plans primarily invested in employer stock	748	1.5 million	$133 billion
Broad-based stock option plans	3,000	9 million	(several hundred billion, not realistic to estimate)
Stock purchase plans	4,000	11 million	(not realistic to estimate)

Approximately 15% of the workforce have some form of ESP.

The dramatic growth in plan assets and in participants in these plans over the last few years appears to result from the better performance of ESOP's companies and a huge increase in the number of ESOP's doing acquisitions.

Multiple Plans

Many companies offer multiple plans, and many employees participate in more than one plan. For example, many employees participate in the company's section 401(k) plan and in the companies other stock option and equity compensation plans.

Europe[1]

[1] Changing Patters of Employee Financial Participation in Europe
A survey among listed Firms in six European Member States
Final report by Erik Poutsma (Ed)
Danial Albra, Panu Kalmi, Andrew Pedleton, Stephan Trbucq, Eckhard Vozz

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The situation in Europe regarding the application of financial participation schemes has developed slightly overall since the publication of the initial PESPER Report. There is more encouragement given to financial participation than fifteen years ago in virtually all member states. However, there is a growing disparity between the acknowledged financial participation countries (such as France and the UK) and those countries with the least developed financial participation policies and institutions. Those countries committed to financial participation have taken active steps to develop financial participation further, but these actions have not been followed by other member states. Part of the problem is that there appears not to exist any exchange of information between member states regularly either on legislation or good practices.

In summary:

- There is an increase in the use of schemes in Europe.
- However, the substance of share ownership in Europe is generally small, which means that there are relatively isolated experiments going on.
- There is a growing awareness at all parts of industry that employee share ownership might be a new employee benefit to be applied.
- A growing number of trade unions develops a pragmatic attitude towards the phenomenon and tried to be involved.
- There is a growing need for sharing information and a growing need for models and exchange of experiences on best practices and on solutions for apparent problems that show up when practising these schemes.
- Moreover, following the research and discussions more insight should be acquired concerning employee choices and employee representatives' views.
- And more insight should be gained on the views of the social partners on this phenomenon.
- Due to bookkeeping scandals and subsequent impact on these types of schemes financial participation are much more critically approached than at century's end and may have lost some broad based support.

Differences Between European Countries

As expected there are large differences between countries. The UK appears to be the country with substantial application of share schemes. France appears to be a country with mandatory profit sharing schemes. Spain appears to be a country with a tradition of co-operatives. Germany is a country with established capital accumulation plans for employees, and the Netherlands and Finland appear to be countries with a national wage saving system. These country differences determine the existence of schemes to a large extent. Most broad based employee financial participation appears to be a result of the possible benefits provided by government policies in certain European countries.

Supportive Legal Context and Government Policy

There is an increase of the use of these schemes in all countries. The development is supported by legislation in certain countries, most notably the UK and France. In these countries financial participation

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becomes sophisticated and to a certain extent part of national sectoral income policy. The main arguments to promote the system is wage flexibility, productivity and wealth redistribution.

Australia in Comparison[2]

In Summary

- In Australia there is conflicting and limited data regarding the implementation of Employee Share Ownership Plans ("ESOP's").
- There is no comprehensive (accurate) survey of the incidences of the various types of ESOP's by business type in Australia.
- The limitations of previous research include a lack of differentiation between:
  - "type" of ESOP and the key factors that are limited take-up;
  - the focus of the ESOP at the company level, and whether the plans are narrow-based plans (offered to top management group only) or broad-based plans (offered to most or all of the employees, generally considered to be greater than 50%); and
  - the size of the entity, and whether barriers to implementation of ESOP's differ by entity type and size.
- Australian incidence of employee share ownership is low compared to a number of other countries, such as USA, UK, France and Japan. However, employee share ownership in Australian is similar to that in Germany. It also appears that employee share ownership is more concentrated among managerial occupations than in some other countries.

Trends and Statistics

The Australian Bureau of Statistics ("ABS") collects data about shares as a benefit of employment; data was collected on this in 1999 and 2004.

As at 2004, 5.9% of the total employees have employee shares as a benefit of employment. This is an increase of 0.4% from 1999 and a total increase of 3.5% from 1989.

Full-time employees constitute 400,600 of the total number of employees. The ABS data indicates an increase of 0.1% to 0.7% from 1999. An estimated 3.4% of the 80,700 total part-time employees also have employee shares, which is an increase of 1.2% from 1999 and a total increase of 2.9% from 1989.

In comparison to other types of employment benefits, the percentage of employees with shares (5.9%) ranked above other benefits such as study leave (4.2%), holiday expenses (3.8%), union dues/professional association (3.0%), medical (2.1%) and child care/education expenses (0.6%).

These statistics indicate that the incidence of employee share ownership is on the increase.

Data from ABS Survey of Employee Benefits and Earnings from 1986-1999 provides the following levels of employee share ownership in main job and occupation:

[2] Research provided by TNS Social Research, ACT

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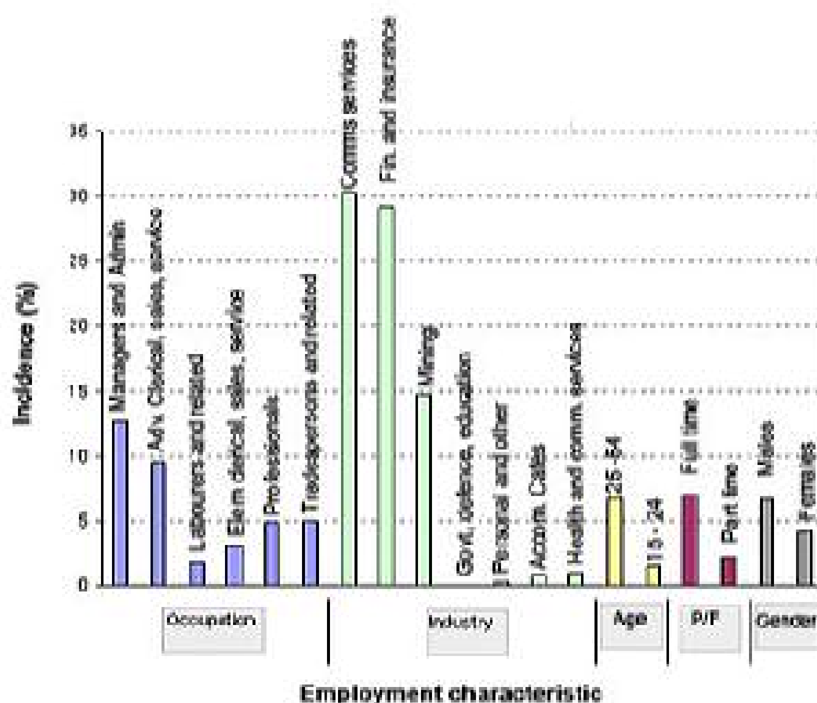
	1986	1987	1988	1989	1990	1991	1992	1994	1999
Total employees in main job (%)	1.40	2.15	3.25	2.39	2.61	2.76	2.83	3.90	5.54
Managers and administrators (%)	5.76	8.67	9.25	8.25	8.46	8.95	8.13	9.79	12.57
Non managers and administrators (%)	0.95	1.70	2.71	1.96	2.21	2.30	2.42	3.42	5.15

As at 1999, an estimated 5.5% of all employees and 12.6% of managers have employee shares.



Listed and Unlisted Companies

A very high proportion of Australian listed companies have employee share ownership plans (estimated to be around 90% of listed companies and 56% of subsidiaries of overseas listed companies have at least one employee share ownership plan, noting some of these are executive only plans (*Mercer, 2002)).* A number of reasons are given by the companies surveyed for this high level or employee equity participation, including developing an ownership culture, attraction and retention, and long-term incentives.

A much lower number of unlisted companies have employee share plans (i.e. estimated to be about 0.9% of companies). According to the House of Representatives Inquiry into Employee Share Ownership, the main reasons for employers not putting plans in place are cumbersome administration, cost implications, and, because difficulties with approval and corporate structures not considered to be appropriate (*Shared Endeavours: an Inquiry into Employee Share Ownership in Australia*). [3]

[3] Shared Endeavors: An enquiry into Employee Share Ownership in Australia

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In the USA 90% of both listed and unlisted companies have employee share plans. This is due to the prevalence of geared ESOP's in the USA's unlisted market place.

ESP's Value

The value of employee share ownership is unknown, but was estimated by the Nelson Committee to be worth between $3 billion and $4 billion in unlisted companies. About $1.5 billion of the total was estimated to be holdings in executive only plans. A significant proportion of the total comes from a small number of very large firms.

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F. ESP's AND COMPANY PERFORMANCE

Overview

Over the past 25 years a wide range of research projects has established that employee ownership, especially when combined with participative management, is linked to significantly improved corporate performance. The research findings have been unusually consistent.

Among the studies already completed, the following are considered the most significant on the connection between ESOP's and company performance. Most of the studies summarised below examined and compared company performance both before and after employee share plans were introduced.

The 2000 Rutgers Study

In this study Douglas Kruse and Joseph Blasi of Rutgers University compared the performance of more than 250 ESOP companies that adopted plans between 1988 and 1994 and a similar number of non-ESOP companies. It found that these companies increased sales, employment and sales per employee by 2.3% to 2.4% per year over what would have been expected without and ESOP. Although at first glance the relative growth numbers may seem small. Projected out over 10 years and ESOP company with these differentials would be a third larger than a company without and ESOP.

The 2000 NCEO Stock Options Study

In this study Blasi, Kruse and Hames Sesil of Rutgers University, and Maya Kroumove of the New York Institute of Technology, studied 490 companies including a survey of 105 companies with broad-based stock option plans and 385 additional companies that offered broad-based stock options to a majority of their full-time employees.

Among a number of findings, the key one related to a comparison of the performance of broad-based stock option companies with non-broad-based stock option companies both before and after they had implemented their option plans. The results showed that broad-based stock option companies had 6.3% higher productivity levels than non-broad-based companies before option plans were implemented, and 14% higher productivity levels than non-broad-based companies after the implementation of option plans. The researchers considered the 7.7% difference as statistically significant.

The 1986 NCEO Study

This study by Michael Quarrey and Corey Rosen of the US National Centre for Employee Ownership (NCEO) was the first to show special causal linkage between employee ownership and corporate performance. It found that ESOP companies had sales growth rates 5.4% per year higher in the post ESOP period than would have been expected based on pre ESOP performance. ESOP companies with highly participative management structures showed by far the biggest gains, growing three to four times faster than ESOP companies without such structures. Other studies suggest the worker ownership without participation can be short-lived or ambiguous. Ownership appears to provide "the cultural glue" to keep participation going.

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The New York and Washington Studies

In 1997 economist Gorm Winther and Colleagues followed up the NCEO study with a study of 25 employee ownership firms in New York and 28 in Washington State. In both studies, employee ownership per se had little or no impact on corporate performance, but substantial impact when combined with participative management. In Washington State, ESOP companies grew in employment by 10.9%, and in sales by 6% per year more than would have been expected. The New York results were similar. In Washington State, majority employee-owned firms that were particpatively managed did even better.

The GAO Study

In 1987 the US General Accounting Office (GAO) studied 110 firms focusing on productivity and profitability. The study found that, while ESOP's had no impact on profits, participatively managed employee ownership firms increased their productivity growth rate by 52% per year. In other words, if a company's productivity growth rate were 3.0% per year, it would be 4.5% percent after an ESOP. Due to the particular methodology used these results were are considered conservative.

The 1998 Employee Compensation Study

Carried out by Peter Kardas and Jim Keogh of the Washington Department of Community, Trade and Economic Development, and Adria Scharf of the University of Washing, this study matched 102 ESOP companies with 499 comparison companies. It found that employees in the ESOP companies were "significantly better compensated". In terms of wages, the median hourly wage in the ESOP firms was 5% to 12% higher than the median hourly wage in comparison companies. The study also found the average value of retirement benefits in ESOP companies was equal to $32,213, with an average value in the comparison companies of about $12,735.

The 1998 Hewitt Associates Study

This study by Professor Hamid Mehran, formerly of Northwestern University J.L. Kellogg Graduate School of Management, in partnership with Hewitt Associates, found that ESOP's in 382 publicly traded companies increased the return on assets (ROA) 2.7% over what would otherwise have been expected. Mehran also found that for the 303 ESOP companies surviving the entire 4 year, post ESOP study period, ROA was 14% higher than the comparison group scores. He also found that while for the 382 companies as a group, ROA was 6.9% higher for the 4 year period. Over 60% of the companies surveyed experienced and increase in their stock price, averaging 1.6%, in the two day period following public announcement of the ESOP, illustrating that the stock market now reacts positively to ESOP's, instead of concluding that the company is trying to prevent a hostile takeover.

The 1998 Study of Stability of Public Companies

Margaret Blair, Douglas Kruse, and Joseph Blasi found that publicly traded companies that are 20% or more owned by an ESOP are more organisationally stable. Looking at companies between 1983 and 1996, the study found that 74.1% of the ESOP companies remained as independent operations while only 37.8% of the comparison companies did. None of the ESOP companies went bankrupt, but 25% of the comparison companies did.

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The 1990 Michigan Study

The Michigan Centre for Employee Ownership and Gainsharing and Michigan State University asked executives to indicate if employee ownership had had an impact on sales, profits, productivity and other measures. The results were most positive in companies that scored high on participative management measures. The study also found that the incidence of employee participation programs increased 50% to 100% after an employee ownership plan was set up.

This pattern of dramatic increase in participation after ESOP's are set up was confirmed by a 1993 Ohio Employee Ownership Centre study.

Oxera Study

Oxera was commissioned by HM Revenue & Customs (formerly the Inland Revenue of United Kingdom) to examine the impact of tax-advantaged share schemes on UK company performance (whereby companies' reward their employees by granting them shares, or share options, as part of their remuneration package).

Initial Findings

- Larger companies, as measured by number of employees (but also turnover and amount of capital employed) are more likely to operate schemes. Large companies are also more likely to operate multiple schemes.

- Analysis of schemes by industry sector reveals that around 80% of all share schemes are concentrated in four industry sectors (being manufacturing; real estate, renting and business activities; wholesale and retail trade; and financial intermediation). When taking into account the total size of each industry, companies belonging to the electricity, gas and water supply, mining and quarrying, financial intermediation, and manufacturing sectors are shown to be most likely to operate a share scheme.

- Companies in any industry are more likely to operate a discretionary CSOP scheme that either a SAYE or APS all-employee scheme.

- On average, across all industries and years examined, 36% of companies with schemes are listed. The number of companies with a scheme that are listed has increased over time to almost 50% in 2001/2002. Between 38% (mining and quarrying) and 74% (manufacturing) of all listed companies across industries operate a share scheme.

- Companies in the electricity, gas and water sector are most likely to operate any type of share scheme. When focusing the analysis on listed companies, the sector in which companies are most likely to operate a share scheme is manufacturing (74%).
- Listed companies with schemes tend to have the same or higher levels of productivity (capital or labour) and profitability as listed companies without schemes.

- Additional modelling shows that companies are more likely to operate schemes the more capital-intensive they are. The analysis also indicated that companies are more likely to have share schemes under favourable economic conditions.

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Key Findings

However, this only paints a partial picture and more complex analysis (namely econometric modelling) is required to examine the impact of share schemes, controlling for other factors. This econometric analysis therefore provides a more definitive assessment of share schemes and their impact. Using dynamic panel data modelling, Oxera identified the following key points at the aggregate level (i.e. across all firms).

- On average, across the whole sample, the effect of tax-advantaged share schemes is significant and increases productivity by 2.5% in the long run.
- However, when the schemes are analysed on a disaggregated basis, there is a 4.1% long-run improvement in performance for companies using SAYE schemes, but no significant improvement for CSOP or APS schemes.
- Critically, there are further benefits to be gained from operating several types of scheme – when companies have both CSOP and SAYE schemes, productivity increases by 4.4% (i.e., a greater increase than the effect of operating only SAYE).

General Social Survey

New data from the General Social Survey show that 20 million American workers own stock in their company through a 401(k) plan, ESOP, direct stock grant, or similar plan, while 10.6 million hold stock options. That means that 17% of the total workforce, but 34.9% of those who work for companies that have stock, own stock through some kind of benefit plan, while 9.3% of the workforce, but 18.6% of those in companies with stock, hold options.

Confirming this data, an online survey of 2,373 US adults conducted by Harris Interactive between April 11 and 13, 2007 for The Wall Street Journal Online found that 13% of those surveyed said that their company provided stock as a benefit (presumably primarily through ESOP's or 401(k) plans), while 9% said they received stock options.

Employee Involvement

A striking finding of the study is that sharing ownership (as well as profit sharing and gainsharing) is correlated with increased employee involvement in work-level decisions. Cause and effect here are uncertain. It could be that the companies likely to set up participation programs, for instance, are more likely to share rewards, or the causality could go the other way (or both ways). In any event, about 41.6% of employees with options and 43% of those owning company stock are on an employee involvement team, compared to 30.2% for the sample, while 38.6% of those owning stock and 44.0% of those with option are on self directed work teams companies to 33.3% for the entire sample. These numbers understate the difference, however, because roughly 20% of the sample owns stock or options. If these were excluded, the comparisons would be even more significant.

Pricewaterhouse Coopers 2007 Global Equity Incentives Survey[4]

Perhaps the most striking of the themes in the survey results relates to the reported value of equity compensation plans. Since 2003, the majority of survey participants have reported that

[4] Pricewaterhouse Coopers
harnessing the reqrd 2007 Global Equity Incentives Survery

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the benefits to be gained from equity compensation are worth the costs. This year, however, when the "costs" have become more visible than ever before, survey participants almost unanimously (97%) reported that the benefits outweigh the costs, up to 75-80% during the period 2003-2006. When people at all organizational levels are responsible for bringing the company to life, it makes sense that now more than ever stock in the company is viewed as key to the architecture bridging company, customer and shareholder. This is especially the case in those companies where equity compensation continues to be granted beyond the upper management level. This is particularly apparent with plain vanilla stock options, which have value for the employee only when the company stock price increases from the grant date.

The overwhelmingly positive attitude toward equity compensation in today's market is paired with increasing sophistication and movement toward cross-functional alignment reported in the design, valuation, oversight, administration and communication of such plans. Additional key findings of the 2007 Global Equity Incentive Survey include:

- Despite continuing decline in the use of stock options, options continue to be the most popular equity compensation vehicle in virtually all industries and among companies based in every country surveyed. However, participants in this year's survey were only half as likely to grant stock options as those in the 2003 survey.

- Performance ("operating" and "market") based equity compensation plans continue to increase in prevalence.

- The "pay for performance" mantra is resonating both CEO and broader employee populations: over 40% of participants indicate executive pay will change based on performance over the next 12 months and 5 years, and nearly 30% report similar relationship between employee pay and performance.

- There is evidence that cuts in stock option grant sizes were made at all levels of the organisation, not just among the rank and file.

- Companies are willing to modify some of the most basic design features in stock option plans, including lowering contractual term and service requirements (87% of participants in 2003 reported granting options with a 10-;year contractual term, compared with 58% in 2007), and incorporating publicly traded options in developing volatility assumption.

- Market based benchmarking is almost universally employed as a tool to analyse and track compensation plans. As alluded to earlier, multinational companies are keenly focused on market competitiveness, and a significant portion (33% of participants) are bolstering their "toolbox" for granting a full picture of the total rewards package, including equity compensation. The use of analytical tools such as tally sheets in addition to benchmarking is strong among our "All Participants" group than among companies based in Europe, perhaps reflecting the impact of the recent Securities and Exchange Commission's requirement to provide detailed tables of executive compensation in the Proxy statement, or perhaps in response to shareholder feedback.

- Despite the continuing trend indicating that shareholders generally approve equity compensation plans submitted to them, a larger percentage of participants report "no" votes in 2007 than in 2006.

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- Companies continue to seek ways to reduce the after-tax cost of providing equity compensation through the use of cost recharge arrangements between corporate headquarters and local subsidiaries. Under such agreements, local employers must reimburse the parent for the value of the equity delivered to their employees, thereby securing local tax deductions for equity awards.

- On a similar theme, there has been an increase in the prevalence of locally tax qualified plans. The evidence suggests that this is particularly true in countries with high social taxes and where qualified plans are particularly prevalent.

- Plan compliance continues to be a challenge, particularly outside the country where the company headquarters is located. Less than half of participants in 2007 report having conducted a review of the compliance of their equity compensation plans in all countries where equity is granted. However, as the number of countries in which tax authorities have undertaken programs to audit equity compensation plans offered in their country increases, we expect to see companies shift from somewhat reactive, headquarters' country focus to a more proactive, all-inclusive approach to internal compliance reviews in all countries where the plans are offered.

ESO Research Findings of the DEWR End Unit 2006

The key findings of the research are structured around three key areas:

- Awareness and incidence;
- Attitudes and endorsements; and
- Increasing take-up.

Awareness and Incidence

The research confirmed that ESO is a complex area and that while general awareness of the concept among businesses is high, there is a lack of depth of understanding of issues related to design, implementation and management of ESO plans. This lack of knowledge also extends to some advisors, for whom the complexity of specific tax and legal issues can be overwhelming.

Awareness of broad based schemes *("share plans that are open to all employees")* was highest among:

- Public companies listed overseas (87%);
- Companies with over 100 Employees (85%);
- Companies with an annual turnover of over $50 million (81%); and
- Companies with mostly white collar workers (79%).

Lack of familiarity of ESO was reported most often among businesses:

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- In the Health and Community Services industry (70%);
- In the Transport and Storage industry (73%);
- Who rated their organisational culture on a range of measures as Good (65%) or Average (64%) but not Excellent; and
- With mostly blue collar workers (60%).

The incidence of ESO reported in the survey was low, with one in ten businesses (10% having a plan. Only 4% of all businesses had a broad based plan which was open to at least 75% of employees. Industries with higher incidences of ESO were:

- Manufacturing (22%);
- Finance and Insurance (19%); and
- Communication Services (15%).

While there was some variation in take-up by industry, differences across other company characteristics were more prevalent. Larger businesses, for example, were far more likely to have plans, as were publicly listed companies and companies listed overseas. From the qualitative research it was clear that the size of the company was important, if not the most important, influence on the take-up of the ESO rather than the industry of the business or other company characteristics. Smaller businesses often felt ESO was not relevant, too hard and too costly.

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Table 1 – Companies Most Likely and Least Likely to have an ESOP

Most Likely to have an ESOP	***Least Likely to have an ESOP***
• Publicly listed companies (52%)	• Private companies (8%)
• Companies with offices overseas (32%)	• Companies with only one office in Australia (10%)
• Large Businesses: ○ 100 or more employees (30%) ○ More than 50 offices in Australia (39%) ○ Annual turnover of over %50 million (32%)	• Small Businesses: ○ 5-19 employees (9%)

Narrow or executive plans were the most common types of ESO plans reported in the survey. However, the majority of plans implemented in the last year (63%) were open for all employees, indicating a move towards broad based plans over the last 12 months. Of businesses with plans, 40% (4% of all businesses) had a broad based plan which was open to at least 75% pf employees. Among businesses with an ESO plan, most (62%) used shares as the main form of equity.

Attitudes and Endorsement

The research found a high level of endorsement for the notion of ESO among businesses with plans and those without plans. Overall, businesses with plans rated ESO more positively than those without, indicating high endorsement of the concept as a productive human resources strategy for those with practical experience.

Rational for implementing ESO

The findings show that the initial rationale for implementing an ESO plan may vary considerably. The key rationales for action can be broadly grouped into three categories:

(1) Businesses and workplace relations strategy;
(2) Facilitating organisational change; and
(3) Employee benefit/market competition.

Each of these is outlined in turn below;

(1) *Business and workplace relations strategy*

Some businesses described the rationale for implementing an ESO plan as a business strategy providing benefit to the bottom line and directly implementing employee productivity. While seen as an effective workplace relations strategy, businesses were quick to outline the separateness of the scheme from any formal wage setting arrangements, preferring to view the schemes as a benefit offered over and above any salary agreements.

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ESO plans were also used by some to promote an identity or affinity with the business for employees with the intention of influencing productivity and performance, i.e. building a sense of ownership and belonging, focusing and motivating employees. ESO plans were also seen as a means of fostering **two way commitment** between the business and the employee, particularly where the plan asked the employee to contribute ("buy-in"). This was both rewarding for the employee and the business, also working towards achieving long term loyalty from key employees who were seen as vital to the success of the business.

Employee share ownership plans were generally seen as contributing to **improving business performance**. While companies found it difficult to establish a clear (and quantifiable) link between ESO and absolute increase in productivity, some proponents were adamant that their plan had positively impacted on their bottom line and would recommend ESO as an effective business strategy as a result. Other companies saw the main benefit of options in particular as a long term incentive related to **retention and loyalty**, that is, as a powerful human resource strategy to retain key performers given the restrictions on length of service before options could be exercised – a "golden handcuff".

(2) _Organisational change:_

The literature review revealed the possibility of ESO being a core tool for achieving or supporting organisational change, a view supported by interviews with businesses. This may include, for example, integrating and unifying different parts of a business after a merger or acquisition which was commonly reported among larger businesses in the study.

ESO was also used as a way of achieving a smooth transition of ownership/succession planning for owner operators in smaller family businesses. Particularly in regional areas or specialist areas where sale of the business is nor guaranteed due to lack of buyers when owners choose to retire, ESO provided a way of owners to spend less time in the business and ease into retirement.

Schemes were seen as increasing the interest in company performance, and positively impacting on the culture of the company. Share plans were also reported to create a "vibe" about the office, particularly when employees could track the share price. Business also reported that share plans can align the work of employees with company goals or a changing direction for the business; and/or encourage cultural change in organisations, for example, towards a more customer (or share holder) focused mode of operations.

"We have been doing considerable work over a considerable period of time to try and develop some sort of an ongoing reward scheme for our award staff. That's an area where we believe there is much to be gained for the organisation… primarily from the point of view from driving a workplace culture which values performance and also… aligning individual goals with corporate goals."
(Workplace Relations Manager)

(3) _Employee benefits_

ESO was used by some businesses as a way of attracting and retaining employees in a competitive labour market. For some industries, the decision to include shares

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and/or options in a remuneration package was driven by competitor behaviour and the need to match the marketplace as part of being an employer of choice. This was of course, dependant on the capabilities and skills of "potential" employee shareholders including consideration of their capacity to earn and be "poached" by other employers. One employer who did not currently have an ESO plan was keen to investigate the possibilities:

"We have done quite a lot of work in relation to salary structure for executive staff and… when you look at total employee reward we come out significantly behind the market and that is basically because of the extent of shares and options which exist in the private sector at these executive levels…this area of employee share ownership is one I have been conscious of for some time."
(Workplace Relations Manager)

Received benefits of ESO

The key benefit recognised most frequently among all businesses (with and without plans) (agreement rated 7.3 out of 10) is the recognition of a dual benefit of the plan, that is, ESO benefits <u>both</u> the business and the employee.

The two key findings are:

- Businesses were more likely to agree with benefits related to organisational culture and workplace relations/human resource strategies; and
- Agreement was lowed when considering elements such as the relationship between ESO and effective performance, a better working environment, and competitive salary packaging and tax benefits.

Negative Perceptions and Barriers

The main barriers to increased implementation of ESO plans related to a perception of a lack of relevance of ESO to their business, practical issues regarding legal and tax complexities, and employee resistance. There was also a range of legislative/taxation issues raised in particular by advisors who saw these issues as significant barriers for business. These key issues included:

- Limited tax incentives and/or unattractive and complicated tax treatments depending on the plan type or transfer of ownership (capital gains tax issues);
- Burdensome corporations law disclosure requirements; and
- Annual valuation requirements which can be expensive, complex and difficult for unlisted companies.

The research highlighted the key concerns of **cost and complexity** for businesses wanted implement and ESO plan. The four main negative perceptions emerging from the survey were:

- Businesses without share plans believe that share plans are not applicable to their organisation;

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- Employees would prefer other types of benefits, do not/would not understand ESO and some could not afford to take part of a plan;
- Set up and maintenance costs are expensive; and
- Legal requirements are too difficult.

Employee Perspectives

As noted above, employee resistance was one of the most frequently reported concerns for businesses (with and without ESO plans). Qualitative research with employees found that while in many cases understanding was low, perceptions varied even within organisations. The views of employees towards ESO plans appeared to be driven by a range of factors, including:

- The performance of the share price – share volatility was not well received by some employees and a declining share price was seen as demotivating;
- The size and age of the company – different views for those in smaller or start up phases (i.e. employees can be part of a business growth and development) as opposed to an established or larger business;
- The value and type of shares (needs to be significant/worthwhile);
- Previous experiences (positive and negative) with share schemes;
- Life stage and current financial position – younger employees looking for different types of investments or cash flow compared to those closer to retirement;
- Understanding of share ownership generally and an openness to this type of participation as part of a wealth creation strategy; and
- Existing employee relations and trust of management.

Well designed communication materials and strategies to educate employees and counter resistance were identified as key elements for successful implementation of an ESO plan.

Effectiveness of Plans

The success of an ESO plan is related to the objectives of the scheme which varied across organisations. Considering most plans aimed at impacting such broad areas as organisational culture and employee attitudes, precisely measuring the success of an ESO plan is somewhat difficult. The survey asked respondents to recall the reason why their plan was implemented and rate the effectiveness of their plan against those objectives.

Around half of all respondents rated their plans as being effective, with more than one in ten rating plans as extremely effective. Plans which provided units were the most

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effective plan types, with a quarter 24%) rating them very highly, and the vast majority (86% rating them 7 or higher out of 10 for effectiveness. Shares plans also rated favourably with 71% of businesses rating them as 7 or higher out of 10.

Businesses that rather their plans as extremely effective (rating or 9 or 10) reported the following specific benefits: *share plans*

- Provide benefits to both the business and employees (mean rating 9.6);
- Are a good way to reward and recognise performance (mean rating 9.4);
- Increase loyalty and retention (mean rating 9.2); and
- Mean we can provide better remuneration packages (mean rating 9.1).

The survey found that many businesses were linking their plans to performance hurdles and the majority of these were for executive plans and option plans. The very large majority of these businesses believed that the share plans were positively affecting performance and/or that ESO was a good way to reward and recognise performance. Of those who used performance or recommendation from a manager as a criterion to decide which employees where eligible to participate in an ESO plan, 95% agreed that share plans a re good way to reward and recognise good performance (54% rating 10 out of 10). Almost all these businesses (94%) agreed that employees perform more effectively when they have a share plan.

One of the reasons cited for less successful plans was the volatility of the share price. Common problems also reported by businesses related to plans being difficult to manage and maintenance costs being too expensive. Employees not understanding or preferring other types of benefits, and ESO plans not really being suitable for their organisation were also reported as reasons for plans being less successful.

Additional or alternative strategies to ESO

ESO plans are one of many choices open to businesses wanted to reward, recognise and motivate employees. Of those businesses interviewed, many had in place a variety of reward schemes including gifts, prizes and cash bonuses for both short and long term incentive programs. Alternative forms of financial participation might also include commission schemes, profit sharing or gain sharing. Often those businesses with ESO were also using other strategies:

"ESOP's…are only one plank in a whole range of HR initiatives and so usually companies that have strong share plans and responsive employees probably are doing 30 other things very well as well…if you have a highly motivated work force that is well paid, working in a good work environment being encouraged to participate on every level and they have got a share plan… does that mean it's the share plan that's one the trick or all these other things?" (Advisor).

The research also shows that many businesses simply prefer alternative (more conventional) employee benefits such as profit sharing and often businesses believe that employees would also prefer cash. The survey found that 54% of all businesses agreed (rated 7 or higher out of 10) that there are better ways of rewarding employees

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and 67% felt that employees would prefer other benefits. Of those who preferred other means of reward, 80% were offering al least some employees' cash bonuses.

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G. LTI COMMUNICATION AND EXPENSING

Expensing

"Worldwide" accounting standards now require employee share and option benefits to be valued and expensed in the profit and loss accounts.

Though there was in some quarter's concerns about the requirement to expense equity offerings, it has been universally accepted and implemented.

Communication

What has not been universally adopted is the communication of the "equity" benefits to employees as part of their Total Employment Cost.

The provision of LTI benefits are a cost of employment the same as Salary and Wages, Superannuation and so on, and employees for the purposes of communication and transparency, let alone retention should be aware of the annual value of their LTI benefits.

Valuation

RSG has developed an employee equity valuation calculator (i.e. the RSG Employee Equity Calculator), in conjunction with a noted academic from a leading university, who specialises in the valuation of options and other equity. The valuation of the employee share options and all forms of employee equity needs to be based on the methods outlined in the AASB 2, which is the Black and Scholes model or a binominal model, with a careful and detailed calculation of the valuation volatility factors.

The RSG Equity Calculator incorporates a 250 step, binominal tree structure, which allows for inclusion of employee vesting conditions, employee turnover rates and early exercise as required by the accounting standards.

It is the determination of the volatility factor that is one of the keys to accurately value share options and other equity. Volatility represents the potential for the option and share benefits to grown in value over the period the employees hold the equity. Accurate determination of the appropriate volatility requires careful analysis of the fluctuations in the company's share prices.

Where a company has little in the way of historical valuation data, it is understood ASIC is applying the arbitrary volatility factor of 65%. Most mature companies exhibit a volatility factor of around 20-30%. However, newly established, more speculative mining or hi-tech companies can exhibit unsustainable volatility factors in excess of 100%.

It should be emphasised that the valuation of share-based payments are not limited to employee option plans. For example, many companies have loan share plans (i.e. employees are given an interest free loan by their employer to invest in the company's shares) and they will also need to disclose and expense the value of this equity. Generally speaking, the value of employee loan plans can be determined on a similar basis to employee option plans but without the lost dividend yield cost factor.

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Also, it is not limited to public companies, the requirement to expense LTI benefits applies to all employers who are offering "equity" benefits in lieu of services performed.

Typical employee share option scenario

(Source: Employee Shares in Volatile Markets by Gary Fitton, Director, Remuneration Strategies Group, Thomson Reuters, Weekly Tax Bulletin, No 8, 27 February 2009).

Option Valuation

The options proposed to be offered to employees would need to be valued and expensed under the relevant accounting standard, being AASB 2, under a Black Scholes Merton methodology.

Growth-only valuations

Utilising the RSG Equity-based Remuneration calculator, each growth-only or geared option would be valued at 75 cents.

This valuation is based on the following assumptions:

- a share price of $4.00;
- a "strike" or exercise price of $4.00;
- a call life of 5 years;
- a vesting period of 3 years;
- a risk-free interest rate for the company of 3.25%;
- a lost dividend yield of 5.5%;
- a volatility factor of 30%; and
- staff turnover of 5%.

For the gross remuneration cost of $200,000, the employee would receive 266,666 options.

Growth in share value

As the options have been issued with an exercise price at the prevailing market value of the shares, the only basis for providing a benefit under this arrangement is from the growth in the share value, over the period the options are held unexercised by the employee. This is referred to in colloquial, general business parlance, as a "growth-only" benefit.

Zepo

We have also valued zero exercise priced options (Zepos), as an alternative to be considered in contrast to the growth-only options.

The value of the Zepos, utilising the RSG Equity-based Remuneration calculator, will be $3.41 per option.

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This valuation utilises the same assumptions as the growth-only options, except, of course, the "strike"' or exercise price will be zero.

Practical Example

Based on recent cost/benefit analyses of alternatives for various option-based delivery methodologies for employee long-term incentives and employee retention mechanisms, we prepared a comparative summary of the cost/benefit attributes of a range of those alternative equity based, long-term incentive (LTI) delivery facilities.

We will assume these comparisons have been prepared for a Large Mining Company (LMC).

Assumptions

- The employee receives a relatively low fixed remuneration and is "topped up" with substantial share option-based incentives;
- the employee has a marginal income tax rate of 46.5%;
- the amount of the long-term incentive (LTI) is $200,000;
- options are issued for nil consideration;
- exercise price is at the prevailing market price of the share (eg $4);
- vesting period of 3 years;
- share value of $10 at the end of year 3 (refer **Table 1**);
- we have also provided examples or share values of $4, $2 and $1 respectively at the end of year 3 (refer **Tables 2 and 3**);
- LMC AASB2 option value of 75 cents, expensed over the 3-year vesting period;
- LMC AASB2 Zepo option value of $3.41, expensed over the 3-year vesting period; and
- we assume the share is sold as a consequence of option exercise, but this would only need to occur in Examples 1, 2 and 3.

Three examples are set out below.

Option Example 1: Growth-only option with s 139E election

The s 139E election to be taxed upfront will have a taxable value of 11.6% of the $4 market value of the share (refer s 139FK-FM of the ITAA 1936), being 46.4 cents per option.

The employee will pay 21.6 cents per option income tax (i.e. assuming a 46.5% income tax rate), and will establish a CGT cost base of 46.4 cents per option.

When the employee exercises the option and sells the $10 share to pay the $4 exercise price, the employee will:

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- have paid income tax upfront of 21.6 cents on the option acquisition;
- pay CGT of $1.29 (i.e. $10 - $4.46 = $5.54 x .5 x .465 = $1.29); and
- receive net after-tax proceeds of $4.50 (i.e. $10 - $4 = $6 - [$0.216 + $1.29] = $4.50).

The employee will receive 266,666 options (i.e. $200,000 divided by 75 cents).

Upon exercise of the options, the company will receive an amount of $1,066,667 as an accretion to issued capital. It will also have received a tax saving of $60,000 in respect of the tax deductible contributions to the Plan Trustee.

The AASB2 value of 75 cents per option will be debited to the employee's gross remuneration package as a long-term incentive/retention benefit.

The employer will expense the AASB2 value of 75 cents over the 3-year vesting period (i.e. at 25 cents per year).

The employer will receive an income tax deduction under s 8-1 of the ITAA 1997 for contributions to the plan trustee (i.e. equal to the 75 cents AASB2 value of the options) upfront in the year they are incurred (refer ATO Interpretative Decision ATO ID 2002/1074).

We have assumed that the share is sold upon the exercise of the option, because the employee will need to sell the shares to pay the exercise price, in the so-called “cashless exercise” process that has typified most Australian employee option plans over past decades.

This process undermines the potential for the equity of LCM to act as a sustainable incentive, as it acts to dissipate the equity held by employees. It turns the employee share plan into a short-term speculative exercise, rather than an ongoing and long-term investment and goal alignment strategy.

The other concern with this arrangement is that, if the share price remained at $4 or dropped to $2 or $1, the employee would derive no long-term incentive benefit under the plan (see **Tables 2 and 3**).

Another problem with this alternative is encouraging the employees to make the s 139E election and pay the tax upfront on an option they cannot dispose of for 3 years.

In this case, the upfront income tax would amount to $57,536, which, if the options were underwater, the employees could only retrieve (i.e. with interest) from the ATO upon cancellation of the options or at the end of the 5-year option life. Short of mortgaging the family home, most employees (including so-called “fat cat” executives) simply do not have ready access to that amount of money.

Our experience is that, as a rule, the s 139E election does not happen and can detract from the general appeal and effectiveness of the plan for employees. Consequently, employees do not retain their shares, as they need to sell the shares to pay the exercise price and the tax on exercise (see Option Example 2 below).

Option Example 2: Growth-only option with no s 139E election

As is typical in these arrangements, the employee will not make a s 139E election to be taxed upfront. Assuming the option to be qualifying rights under the provisions of s 139CD of the ITAA 1936, the employee will exercise at year 3, with the following consequences,

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- sell the shares for $10 each and pay the exercise price of $4 each, resulting in an income taxable discount of $6 per share;
- pay income tax of $2.79 (i.e. $10 - $4 = $6 x 46.5 = $2.79); and
- receive net after-tax proceeds of $3.21 (i.e. $6 - $2.79 = $3.21).

The employee will receive 266,666 options (i.e. $200,000 divided by 75 cents).

Upon exercise of the options, the company will receive an amount of $1,066,667 as an accretion to issued capital. It will have received a tax saving of $60,000 in respect of contributions to the Plan Trustee. The AASB2 value of 75 cents per option will be debited to the employee's gross remuneration package as a long-term incentive/retention benefit.

The employer will expense the AASB2 value of 75 cents over the 3-year vesting period (i.e. at 25 cents per year).

The employer will receive an income tax deduction under s 8-1 of the ITAA 1997 for contributions to the plan trustee (i.e. equal to the 75 cents AASB2 value of the option) upfront in the year they are incurred (refer ATO ID 2002/1074).

While there is no upfront tax for the employee to pay, for the reasons already stated above in the Option Example 1, we believe this alternative to be sub-optimal as the shares must be disposed of to pay the exercise price and the income tax. This dissipates the equity in the employee share plan and, therefore, is an inefficient application of employer shares.

Again, as in Option Example 2 above, the other concern is that, if the share price remained at $4 or dropped to $2 or $1, the employee would derive no long-term incentive benefit under the plan (see **Tables 2 and 3**).

Option Example 3: Zero exercise price option (Zepo)

This example is of a Zero Exercise Price Option (Zepo), provided as a long-term incentive. It can also be structured as, so-called, performance rights or restricted shares.

The AASB2 option value of $3.41 will be expensed in the accounts of LMC over a 3-year vesting period. This is based on a share value of $4, discounted by the cost of options not being capable of paying dividends.

We have assumed the employee will not make a s 139E election, as the taxable discount for s 139FC purposes will be the full marker value of the share (i.e. $4). Consequently, had the employee elected to pay tax on the acquisition of the options, he or she will be liable for income tax upfront of $1.86 per option and will have a CGT cost base of $4 per option. As the employee is being offered 58,651 options (i.e. 200,000 divided by $3.41), he or she would be liable for a total of $125,513 income tax on the acquisition of the options.

Interestingly, Zepo-based option valuation is one of the few occasions that the Div 13A valuation for tax purposes will be greater than the accounting valuation for AASB2 purposes. This is due to the fact that the Div 13A valuation does not factor in the cost of the options not being able to pay dividends. To that extent, the Div 13A valuation actually overstates the value of the option for taxation purposes at acquisition.

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The employer will make a tax deductible contribution of $3.41 to the plan trustee to acquire an option as a fresh issue.

The trustee will have acquired the option for its market value of $3.41 and allocate the option to the employee.

The AASB2 option value of $3.41 per option will be debited to employee's gross remuneration package as a long-term incentive/retention benefit.

The employee will acquire the options with the following consequences:

- no dividends are payable until the options are exercised into shares. The trustee will distribute any dividends;

- the employee exercises the option and receives $10 per option as an income taxable benefit;

- the employee will receive net after-tax proceeds from exercise and sale of the shares of $5.35 per option (i.e. $10 - $4.65 = $5.35).

The employer receives a tax deduction for the contribution of $3.41 per option, resulting in a net tax saving of $60,000.

Upon exercise of the options, the company will receive no further amount as accretions to issued capital. As there is no exercise price to pay, the employee will not need to sell the shares to pay the exercise price, but will need to sell the shares to pay the income tax.

For LMC, this means that the equity in the employee share plan is dissipated and has no incentive and goal alignment attributes over the long term.

Conclusion

Where the shares grow in value to $10, Options 1 and 2 are clearly the optimal equity delivery arrangement (refer **Table 1**). However, where the shares do not grow in value, Option 3 is clearly the optimal equity delivery arrangement (refer **Table 2**). However, these equity delivery arrangements should not be viewed as mutually exclusive.

Depending upon the purpose of each proposed allocation of Share Units, the employer may choose to utilise growth-only options or Zepos under the EST arrangement.

The benefit of Zepos, or full-value shares, is that they produce a return to the participating employees even in “bear” or “no-growth” market conditions (refer **Table 3**).

The benefit of growth-only options or loan-based shares (i.e. with the exercise price or loan at the market value of the share at the time of issue of the Share Unit) is that it maximises employee returns in “bull” or “high-growth” market conditions. However, they produce no return to the employee in “bear” or “no-growth” market conditions.

Recently, one insightful listed company proposed to break the LTI into its component parts, being:

- the retention component of the LTI; and

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- the pure incentive component of the LTI.

It then based the retention component of the LTI as a “full-value” ZEPO and the pure incentive component of the LTI as a “growth-only” classical option plan.

This means that the employees would receive:

- their retention benefit, even if no growth in share value occurred; and
- their incentive component, which would maximise their incentive component in a “bull market” or “high-growth share value growth scenario”,

provided they remained with LMC for their requisite service period - which in this case was a period of 3 years.

This combination of full-value and growth-only equity approaches means that employees are encouraged to remain with the company and perform to maximise the growth and profitability potential of LMC, their employing company.

The common underlying deficiency in these 3 alternative option strategies is that none of them facilitate the retention of shares by the participants after exercise, thereby dissipating the employee equity into a short-term cash realisation exercise.

While the Government is proposing to limit the tax deferred model from 1 July 2009.

Ironically, the tax deferred model in Table 2 produces substantially more tax paid (i.e. by $343,999 or 86%), than the tax paid upfront model in Table 1. This tax differential would be even greater if one takes into consideration that very few employees will take up the offer of options if they expect to be taxed upfront.

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Table 1

Table 1			
	OPTION 1 s 139E Election Taxed Upfront	OPTION 2 (Tax Deferral) No s 139E Election	OPTION 3 Zepo
Assumptions			
AASB2 valuation	$0.75	$0.75	$3.41
$ amount LTI	$200,000	$200,000	$200,000
No of units	266,666	266,666	58,651
Exercise price	$4.00	$4.00	$0.00
Market price at sale	$10.00	$10.00	$10.00
Company	$	$	$
Net cash flow	$0	$0	$0
Tax deduction	$60,000	$60,000	$60,000
Receives from exercise	$1,066,667	$1,066,667	$0
Net cash inflow	$1,066,667	$1,066,667	-
P&L AASB2 - Expensing PA over 3yrs	$66,667	$66,667	$66,667
Employee			
Receives $ per share	$4.50	$3.21	$5.35
Pays tax to upfront	$57,536	-	-
Receives from exercise	$1,199,997	$855,998	$313,783
Total Tax Paid	**$399,999**	**$743,998**	**$272,727**

Table 2

Table 2: Comparative Market Prices at Exercise and Sale			
	OPTION 1 s 139E Election	OPTION 2 No s 139E Election	OPTION 3 Zepo
Market price at sale			
$10			
Company net cash inflow	$1,066,667	$1,066,667	$0
Employee receives	$1,199,997	$855,998	$313,783
$4			
Company net cash inflow	$0	$0	$0
Employee receives	$0	$0	$125,513
$2			
Company net cash inflow	$0	$0	$0
Employee receives	$0	$0	$62,757
$1			
Company net cash inflow	$0	$0	$0
Employee receives	$0	$0	$31,378

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Table 3

Table 3: Tabulated Summary

Example	Net return to employee								Dividends	Tax upfront	Shares retained in plan
	$10 share price	Tax	$4 share price	Tax	$2 share price	Tax	$1 share price	Tax			
1	$4.50	$1.50	0	0	0	0	0	0	No	Yes	No
2	$3.21	$2.79	0	0	0	0	0	0	No	No	No
3	$5.35	$4.65	$2.14	$1.86	$1.07	$0.93	$0.535	$0.465	Yes, after Option Exercise (5.5% yield)	No	No

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