SUPPLEMENTARY SUBMISSION ON EMPLOYEE SHARE OWNERSHIP

PREPARED BY

THE AUSTRALIAN EMPLOYEE OWNERSHIP ASSOCIATION

FOR

THE HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON EMPLOYMENT, EDUCATION AND WORK PLACE RELATIONS

28 JUNE 1999

The Australian Employee Ownership Association (AEOA) wishes to make the following submission to the inquiry of the House of Representatives Standing Committee on Employment, Education and Workplace Relations into:

> *"The extent to which employee share ownership schemes have been established in Australian enterprises and the resultant effects on:*
>
> > *(a) workplace relations and productivity in enterprises; and*
> >
> > *(b) the economy."*

Executive Summary

In this submission the AEOA

- outlines the nature and purpose of Employee Share Ownership Plans (ESOPs);
- discusses their occurrence both here and in the United States of America;
- addresses their contribution to workplace relations and productivity;
- describes and assesses the Federal legislative provisions for ESOPs; and
- indicates future directions for the expansion of employee ownership in Australia.

The AEOA recommends in connection with existing legislation

1. Raising, in the case of small companies, the present limit on individual employees holding through an ESOP more than 5% of voting shares.
2. Lifting the prohibition against ESOPs using equities other than ordinary shares and to allow for the use of other equity types useful to small business.
3. Enabling employees who benefit from a tax-deferred ESOP to defer the tax liability on shares acquired until whenever they dispose of their shares.
4. Modifying prospectus requirements imposed by Corporations Law in order to encourage the implementation of ESOPs among unlisted and small private companies.

In regard to proposed legislative changes the AEOA recommends

- that ESOP trusts be exempted from the Ralph Committee proposal to tax trusts as if they were companies.

Finally, in order to raise the profile of ESOPs at the Government level, and to assist Government in pre-empting the development of legislative and administrative road blocks to the smooth development of employee ownership, the AEOA recommends

- the establishment of a standing advisory committee representing the Federal Government, the AEOA, and ESOP companies and consultants, to advise Government on the design and implementation of suitable measures to promote the growth of employee ownership.

About the AEOA

The AEOA was formed in 1986 to promote the benefits of employee share ownership. The AEOA is conscious of the great need for increased democratic capital formation in the Australian economy. Capital formation by employees provides, we believe, an effective way to increase productivity, income, national savings, and employee participation in company operations. It also encourages the control of companies by those individuals who have the greatest knowledge, experience and commitment to the business.

What is an ESOP?

An ESOP is a financial structure designed to enable employees to buy a share of the business which employs them.

ESOPs are intended as a major social reform. Their purpose is to enable classes of people who historically have not been owners of businesses to become, for the first time since the Industrial Revolution, significant business owners.

ESOPs mean that people who have been marginal, in historical terms, to the ownership structure of free enterprise societies, can become fundamental to it. The effect of the widespread use of ESOPs would be to create a new class of small capital owners - in sum, a diversification of equity ownership which, until now, has been dominated by elite individuals and remote institutions. ESOPs represent both a diagnosis of, and a solution to, a major problem. ESOPs are based on the idea that the key defect of capitalism is that there are not enough capitalists. They also provide a way creating new, smaller capitalists.

There are two ways in which an ESOP structure can be employed to deliver on these objectives. First, ESOPs can be used as an ownership transfer mechanism under which the ownership of existing capital is passed from one set of owners to new entrants into the ownership system. Secondly, and most importantly, ESOPs can be used by would-be owners to create new capital to which they secure the title. Thanks to the ESOP, both of these objectives can be obtained, not by revolution, confiscation, or theft but by using the financial mechanisms developed in free economies for the normal conduct of business.

Sources of ESOP funding: tax implications

The purchase by an ESOP of shares in an employer's company can be funded by loans (whether from the employer or from third party financiers), out of profit, performance bonuses, fixed wages and salary, or by some combination of these. In this submission the AEOA makes proposals which are based upon the preservation and, in certain respects, the extension of existing ESOP-favourable tax provisions which support funding arrangements of this kind.

Support by taxation law in the form of tax deductions for employer contributions to ESOPs, and tax deferral (or exemption) on the value of shares acquired by employees, have formed a central part of the ESOP policies of governments here and abroad.

The fundamental reason for providing this support has been to promote the social objective of diversifying capital ownership and increasing the stake which ordinary people have in the free enterprise system. At the practical level, this has required measures to facilitate the financing of employee equity in a way which would encourage both existing business owners to embrace employee ownership and employee owners to hold their newly acquired shares for the long term. Unless existing owners are willing to 'sell' and employees willing to 'hold', then the social objectives of employee ownership will not readily be achieved. Tax deductibility and tax deferral have played, consequently, a vital role in making employee ownership happen.

Central to understanding the rationale for such measures is the fact that employee ownership seeks to extend the capital ownership culture to people who, historically, have not had, and still do not have, adequate savings to buy into a business. If such people were to be taxed prematurely on the value of a capital stake acquired through an ESOP, then they would be obliged to sell it in order to meet their tax obligations. This would defeat the purpose of employee share ownership.

Rather than see their employee ownership policies thwarted in this way, governments have provided tax deferral to employees benefiting from an ESOP to encourage them to hold, and to build up, their capital stock. Without this deferral, employee ownership would be impotent as a social policy. Therefore, if governments wish to promote employee ownership, they need to preserve and extend tax deferral for employee owners.

Historical Origins of the ESOP

ESOPs were conceived, and then designed, by the American commercial lawyer and philanthropist Louis Kelso.

Kelso's ideas were developed and fleshed out philosophically in collaboration with the noted American philosopher Mortimer J. Adler. Their joint efforts resulted in the publication of two major works *The Capitalist Manifesto* (1958) and *The New Capitalists* (1961).

One of their key ideas was that a democratic capitalist society like the United States of America could develop as an authentically democratic and just society only if the masses of ordinary people were themselves owners of wealth-producing assets. Kelso and Adler took the view that, unless capitalism was a mass phenomenon, then America might remain capitalist but it would cease to be democratic. This judgement still stands today.

Under the impetus of these convictions Kelso modelled the ESOP to accord with established principles for buying, and funding the expansion of, businesses. Chiefly, he looked to the financial mechanisms used in corporate takeovers.

The first ESOP implemented by Kelso was in 1956. It was used to enable the employees of a company called Peninsula Newspapers Incorporated to buy-out its major shareholders. (The employees paid out the investors over eight-and-a-half years without having to raise a single dollar in debt. The employees used their profit shares in the company to finance the buy-out.)

ESOPs in practice

Notwithstanding the purpose originally conceived by Kelso and Adler for ESOPs, employee share plans have been used subsequently for a range of sometimes different (though not incompatible) objectives.

- **Ownership objectives:** ESOPs can be used to transfer ownership of part, or of the whole of a company, to the employees. More importantly, ESOPs can also be used by employees to increase the existing capital of a company - the classic Kelso conception. This way employees secure a stake in a business in return for their contribution to its capital expansion.

- **Remuneration objectives**: ESOPs can be used as a remuneration and employee-incentive vehicle. In this case, shares in the employer's company are used as a performance-related supplement to existing salary and wages and as a means of enabling employees to share in the long term growth of a business.

- **Workplace change objectives**: Shares delivered through an ESOP can also be used to 'change the culture' of a company. In this case share ownership is used as a means of breaking down perceived 'class barriers' in the work place, as a way of attempting to solve problems posed by the sometimes apparent mutual detachment of employers, managers, and owners from each others' interests.

Each of the three major purposes of employee ownership can co-exist though, at particular times and in particular cases, one of the major purposes will tend to dominate. In the USA, for example, where employee ownership is quite advanced, all three factors are in evidence. However, ownership considerations are very powerful in the US and often predominate.

In Australia, where employee ownership is at an embryonic stage, and where management has taken the lead in promoting ESOPs, remuneration and cultural change motives hold sway.

Extent of ESOPs in Australia

In Australia employee ownership is still at an early developmental stage. Research into the prevalence on employee shares plans here is neither wide nor deep. The AEOA has just initiated a study of share plans in the Top 500 publicly listed companies. The results of this will not be known until 2000. According, however, to the best evidence currently available[1] 74 per cent of Australia's Top 350 listed companies have some kind of employee share ownership plan. Superficially this sounds good. But the picture is quite different once one looks more deeply.

The first thing to notice is that 55 per cent of these plans are option plans. In Australian terms that normally means an executives-only share plan. Another 24 per cent are loan plans that, once again, mostly benefit executives - though there are some notable exceptions, e.g. BHP's employee share plan is loan-based and targeted at general employees. Much the same can be said for partly paid plans representing 13 per cent. Subscription plans, which are funded out of a company's total remuneration budget and which tend more often to be aimed at rank-and-file employees, rate only 8 per cent. (See Attachment A.)

Another way of looking at the spread of share plans is to examine the incidence of plans according to their size. Out of the Top 350 companies only 65 (or 18 per cent) had a "substantial" share plan, i.e. a plan with greater than 50 employee participants and/or holding more than 2 per cent of the company's capital.

In summary, this evidence highlights that even among the Top 350 companies share plans tend to benefit the few rather than the many.

There is, however, a further caveat to these remarks. One cannot extrapolate from the Top 350 listed companies the trend for unlisted companies. The reason is that it is inherently easier for listed companies to implement ESOPs because they can provide a public market for their shares. Unlisted companies, however, have to provide an internal market. This imposes an extra burden upon the implementation of an ESOP in an unlisted company.

Furthermore, while shares issued to employees of listed companies are covered by prospectuses required for the listing of company 'stock', unlisted companies face major prospectus hurdles. In order to issue shares to their employees, they must first meet ASIC prospectus requirements. Putting together a prospectus can be a daunting and excessively expensive business. As a result, the need to issue a prospectus has become the single greatest obstacle in the way of expanding employee ownership in the unlisted company sector of the economy.

The problems faced by unlisted and by private companies in implementing ESOPs are one of the major obstacles in the path of the development of employee ownership in Australia.

For all intents and purposes, therefore, employee share ownership is limited to the 13 per cent of employees who work for listed companies. Out of this group of employees only a minority can presently claim, thanks to an ESOP, to be shareholders of the companies which employ them.

[1] Remuneration Planning Corporation, *The Employee Share Plan Report 1997.*
(This *Report* is currently being updated by the Remuneration Planning Corporation and new figures are predicted to show an increase since 1977 in the number of general employee Subscription share plans among Top 350 companies.)

Extent and Nature of ESOPs in USA

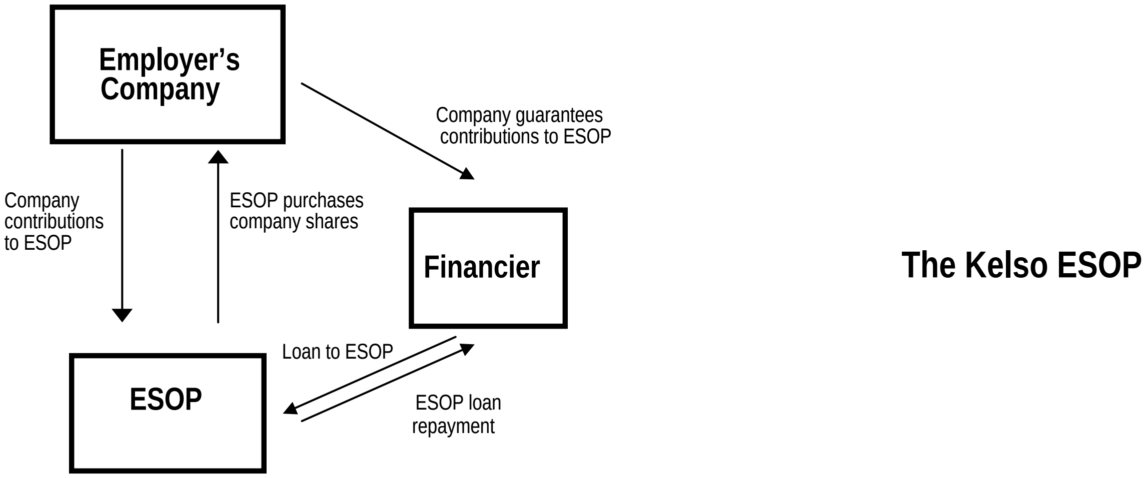
Employee share ownership is a significant workplace phenomenon in the USA, Great Britain, France and Japan. Employee ownership is also a powerful force in Italy and Spain, though in these countries it manifests itself through the co-operative movement which, unlike the Anglo-Saxon world, has reached a high level of complexity, sophistication, and social integration. The seed of employee ownership has also been planted in Eastern Europe chiefly as a by-product of the privatisation of state-owned enterprises.

Given that employee share ownership in the USA is probably more advanced, widespread and deeply rooted than elsewhere, and given the fact that Australian ESOP practice has drawn upon American experience, it might be useful to look at the US situation for some pointers as to where Australia could be headed on employee ownership.

The Kelso ESOP

According to the latest figures supplied by the US National Center for Employee Ownership[2] (NCEO), there are about 11,000 firms in the States with Kelso ESOPs and stock bonus plans covering over 7.7 million employees who own, as a result, an estimated $US400 billion worth of company stock.

Comparability between US and Australian figures, however, poses a problem. The American ESOP, strictly so termed, hardly exists at all in Australia. To American employees and employers an ESOP is a leveraged share purchase instrument. It looks like this:



This is the Kelso ESOP. With an instrument like this a group of employees can buy-out - or substantially buy into - their employer over a period of, approximately, 3 to 5 years. It works in the same way as a corporate takeover. Alternatively, the ESOP can be used to finance expansion of a company's capital base in return for which the workers become owners of the newly created capital.

The 401(k) Plan

In the USA there are other kinds of employee share plans. One of the most important is the so-called 401(k) plan named after the section of 1974 Employee Retirement Income Security Act (ERISA) which gave the plan legal foundation. Unlike the Kelso ESOP, the 401(k) is not leveraged. It is typically funded out of remuneration. Employee profit shares, salary sacrifice, and matching employer contributions are used to purchase not merely shares in the employer's company but also shares in other listed companies. The US Congress obliged 401(k) plans to invest partly in non-employer equities as a prudential measure. In establishing the 401(k) plan, Congress sought to develop an alternative to the Kelso ESOP so that workers could take a stake in their employer's company without having all their eggs in the one basket.

[2] National Center for Employee Ownership Inc., *Employee Ownership Report*, January/February 1999.

The 401(k) is important to a discussion of employee ownership in Australia for a number of reasons. One is the way it is financed. In this regard the 401(k) is more akin to Australia's typically unleveraged ESOPs (discussed below). A second reason is that the 401(k) has proved a very effective way of increasing worker ownership. On top of the $US 400 billion owned by employees through traditional Kelso ESOPs, an estimated $US 250 billion is owned by about 2 million employees through the agency of some 2000 401(k) plans.

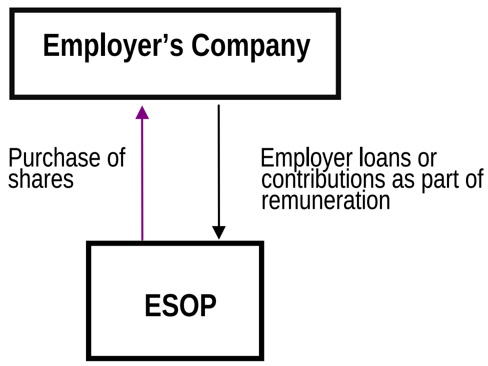
Furthermore, approximately 3,000 US companies, covering another 7 million employees, give 'stock options' to all their full-time employees. This is a more recent development and is currently the fastest growing employee ownership sector. (For a summary of American ESOP data see Attachment B.)

Taking Kelso ESOPs with 401(k)s and stock option arrangements, employee share ownership is rapidly growing in the USA. It has been estimated that by the year 2000 a quarter of all public companies will be more than 15 per cent owned by employees and that 25 per cent of all private companies will have an employee share plan of some kind. Australia's employee ownership performance is a long way behind that kind of result.

Finally, a major difference between the USA and Australia is that here ESOPs are limited, for all practical purposes, to listed companies, while in the United States the overwhelming majority - according to the latest estimate, 90 per cent - of ESOPs are in unlisted businesses.

The Australian ESOP

The typical Australian general employee share plan - in so far as its financing is concerned - is not unlike the 401(k) plan, though here we are restricted to purchasing employer-company shares. A typical plan looks like this:



The Australian ESOP

While this structure is conservative, it is well adapted to the Australian workplace culture where employee ownership is a comparatively new development. With an instrument like this a group of employees can still buy-out - or substantially buy into - their employer's business. But it will take somewhat longer than with a leveraged American-style ESOP (about 7 to 15 years). The more modest Australian cousin provides, nevertheless, an effective "succession planning" tool, if implemented early enough. A private owner could introduce a plan like this at, for example, age 55, sell the company over ten years to the employees, and retire at 65 with an ESOP-funded retirement package.

Our Australian-style ESOP may be a less powerful tool than the Kelso model, but it can easily be upgraded. It may not be leveraged at present. But there is no reason why it can't be leveraged in the future. Once employees and employers begin to understand more clearly the merits of employee ownership and the possibilities of expanding businesses, and creating new jobs, through ESOP financing, they might wish to have a more high-powered ESOP at their disposal.

ESOPs, Workplace Relations, and Productivity

Before examining the legislative basis for ESOPs in Australia and assessing its adequacy, it is important to say something about the connection between employee ownership and company performance.

One rationale for implementing an ESOP is to change the ‘workplace culture’ from one where employees, allegedly, are ‘alienated’ from the interests of owners and investors and from the success of the company as a business enterprise. Employee share ownership has been proposed as an antidote to this problem on the grounds that substantial levels of employee ownership have the effect of identifying the interests of workers with those of other stakeholders. This raises the question of whether ESOP companies really are more productive than non-ESOP companies.

While the body of research into this question is not large, what work has been done tends to confirm what commonsense would predict: that employees who have a significant direct equity stake in a business have a strong tendency to work and think like owners to the great advantage of the business which employs them.

Summary of select research

Some key research projects into ESOPs and company productivity have made the following findings:

- A comparative survey of US companies showed that those which introduced an ESOP improved their productivity by about 3.5 per cent per year compared with industry peers which did not have an ESOP. When the best performing ESOP companies were compared with the other ESOP companies, it was found that the most successful had high levels of employee participation expressed by a variety of formal and informal arrangements intended to encourage employees to exercise judgment and to assume additional responsibilities.[3]

- A study of Japanese ESOP companies indicated that companies enjoyed a 4 to 5 per cent increase in productivity increase after implementing an ESOP, although the productivity effect took from 3 to 4 years to manifest itself.[4]

- A new study undertaken for Hewitt Associates and Professor Hamid Mehran, formerly of the Northwestern University’s J.L. Kellogg Graduate School of Management and presently with the Federal Reserve Bank of New York, indicates that companies which introduced an ESOP experienced a Return on Assets 2.7 per cent higher than industry peers without an ESOP for each year of a four-year study. The ESOP companies also had a cumulative four-year Total Shareholder Return 6.9 per cent higher than the average returns of non-ESOP companies in the study.[5]

Employee Ownership Index

Beside academic inquiries into ESOP performance there is one important market-based tool in the USA for measuring the performance of ESOP companies against their peers. The Employee Ownership Index (EOI) tracks the performance of some 350 stocks in US listed companies with 10 per cent or more broad-based employee ownership. The EOI index was developed in 1992 on the basis of research undertaken by professors Joseph Blasi, Douglas Kruse, and Michael Conte and is maintained by American Capital Strategies, an employee buy-out and specialty finance company. The performance of the EOI companies is measured against various indices including the Dow Jones

[3] Quarrey and Rosen, *ESOPs = performance*, in Industrial Participation, Autumn 1989.
[4] Jones and Kato, *The Productivity Effects of Employee Stock Ownership Plans and Bonuses: Evidence from Japanese Panel Data*, in The American Economic Review, June 1995, Vol. 85, No. 3..
[5] Hewitt Associates, *Unleashing the Power of Employee Ownership: A Research Report*, July 1998.

Industrial Average and the Standard and Poor's 500. During the period 1992-1998 the EOI, generally speaking, has outperformed both these major indices.[6] (Refer Attachment C.)

Future Directions in Australian Employee Ownership Policy

After the introduction of the new Division 13A of the Income Tax Assessment Act in 1995, the AEOA undertook a major assessment of Australia's legislative position on employee ownership.
This Association took the view that Division 13A provides a sound and secure basis for the implementation of ESOPs in publicly listed companies but is a much less effective instrument where unlisted companies are concerned.

The AEOA outlined its position in its *Future Directions in Employee Ownership Policy* document This identifies the weaknesses in current legislation and outlines how it can be strengthened chiefly in order to spread ESOPs among unlisted companies.

The AEOA takes the view that the fundamental characteristics of Division 13A need to be preserved, but that limited, strictly surgical amendments should be made to it in order that greater flexibility can be provided especially for unlisted companies contemplating the introduction of an ESOP.

The chief reforms to Division 13A proposed in *Future Directions* are -

- Raising, in the case of small companies, the limit on employees holding more than 5% of voting shares.

  Reason: The '5% rule' means that a minimum of 20 persons need to be participants in an ESOP to qualify under Division 13A in the very important case where an ESOP is being used to implement a 'succession plan' under which employees would acquire the whole of the company. However, it would sometimes be impossible, or undesirable, in a small company to muster 20 participants. If they could be mustered, prospectus requirements are likely to be triggered. So either the ESOP fails to qualify, or it qualifies and becomes either prohibitively expensive to implement, or impossible for the employees to acquire the whole business through an ESOP - an elaborate Catch 22.

- Lifting the prohibition against ESOPs using equities other than ordinary shares and to allow for the use of other equity types useful to small business.

  Reason: Many small companies cannot issue ordinary shares without compromising their ownership structure. Yet many such companies still wish to 'cut employees in on the deal' with an alternative equity. A redeemable preference share is a possible solution. Another is a share plan structure based on the US 401(k) model which offers a range of investments to employees. This would also provide a solution for wholly-owned local subsidiaries of foreign companies which cannot offer shares in themselves to employees.

[6] Lisa M. Hollod, *The ACS Employee Ownership Index Update* in Journal of Employee Ownership and Finance, Vol.11, No. 1, Winter 1999.

- Enabling employees who benefit from a tax-deferred ESOP to defer the tax liability on shares acquired until whenever they dispose of their shares.

  Reason: Employees are normally obliged to dispose of their ESOP shares when they sever connections with the company. This is a logical point at which to impose tax. Most employees actually change their employment in much less than 10 years, so tax is typically triggered in a short time. On the other hand, long-staying employees should not be obliged to sell shares just because an arbitrarily chosen number of years has passed. This defeats some of the key objectives of employee ownership: to encourage the build-up of substantial equity and to create long-term commitment to the success of the enterprise. Very importantly, the ‘10 year’ rule is incompatible with the notion of using an ESOP to buy-out a company. It would be a senseless exercise to buy-out a departing owner, for example, and then have to sell all, or a large part, of the company just to pay tax. Once again, an effect radically contrary to the employee ownership interest.

In addition, we propose changes to the Corporations Law designed -

- To lift prospectus requirements in those cases where adequate ‘downside risk protection’ on the value of shares is provided and, in other cases, to provide a regime which would permit the issuing of simplified prospectus-type information to employees in place of a traditional prospectus.

This latter proposed reform would address the single greatest obstacle to the implementation of ESOPs in unlisted companies.

For a full exposition of the AEOA’s assessment of current ESOPs legislation and its reform, the Committee should refer to the attached copy of *Future Directions.*

Lack of strategic vision - and its dangers

Beside inadequacies in the existing legislation, one of the recurrent problems faced by those who wish to implement and operate ESOPs is the lack of an adequate strategic vision by successive Federal Governments, and by the major political parties, on employee share ownership.

The present Federal Government and its predecessor, together with all major parties, claim to support employee share ownership. However, the issue is not high on their agendas as events have proved. Since 1994 successive legislative proposals made by Federal Governments have had - with some difficulty - to be modified in order to correct very adverse implications for employee share ownership. Moreover, new proposals recently have been made, and arbitrary decisions taken by the Australian Taxation Office, which once again threaten the well-ordered development of employee ownership.

- In 1994-95 the former Labor Government proposed subjecting ESOPs to the Fringe Benefits Tax. This would have eliminated employee ownership in Australia. In all, the Keating Government was obliged to change its proposed new Division 13A legislation three times before a satisfactory framework for the development of ESOPs could be formulated.

- In 1998 the present Federal Government had to make far reaching amendments to its new Division 7A (ITAA) legislation to remove “unforeseen” consequences which would have made it financially impossible to implement ESOPs in private companies.

- The proposal by the Ralph Committee to tax trusts as if they were companies will have profound adverse implications for trust-based share plans. At the very least the proposal will render their administration excessively complicated and onerously expensive. As a result, companies will abandon tax-deferred general employee share plans established under Division 13A.

- More recently the Australian Taxation Office implemented a draconian embargo on the issuing of tax rulings, now partially relaxed, for all employee share plan arrangements. This move was in contravention of Section 14ZAL of the Tax Administration Act under which the Commissioner "must comply" with an application for a ruling. The effect of this measure alone must be either that companies will not implement ESOPs or that they will rely upon a "reasonably arguable position" - i.e. a self-assessment of their tax position - and risk damaging financial consequences for themselves and for their employees.

The AEOA takes the view that just as Governments have had to abandon earlier misconceived ESOP-related proposals for legislative change, the present Federal Government should -

- **Exempt ESOP trusts from the proposed new 'entity' taxation system.**

General Recommendation

To address this history of 'muddled' legislative and administrative actions in the ESOP field, to raise the profile of ESOPs at the Government level and, most importantly, to assist Government in smoothing the way for an orderly and gradual development of employee ownership, the AEOA recommends -

- **The establishment of a Standing Advisory Committee on Employee Ownership representing the Federal Government, the AEOA, and ESOP companies and consultants, to advise Government on the design and implementation of suitable measures to promote the growth of employee ownership.**

Further details of this proposal are contained in Attachment D.

Concluding Statement

Employee Share Ownership provides employees with legal title to part of the business which employs them. This, in turn, gives employees a clearly definable stake in their company's success. ESOPs, moreover, provide employees with a method of personal, productivity-linked, wealth creation and saving. More importantly, employee ownership is all about enabling people who historically have stood outside the limited-membership circle of capital owners to become joint-owners of the nation's business enterprises. To reach a goal like this must surely appeal to the political aspirations of all major political parties. If it does not, then it ought to.