Employee Share Ownership Plans (ESOP'S)

Comments regarding issues for small/medium companies and possible solutions to enable such companies to offer participation in ESOP'S

- **Prospectus Requirements**

The ASIC policy statement 49 could be described as a general prohibition on the issue of shares or options to employees of an unlisted company without a prospectus. Whilst the prospectus requirement may not be onerous for companies associating an ESOP with an initial public offering (IPO) they are very significant and often unsurmountable for small/medium unlisted companies.

I recommend the law and ASIC requirements be amended so that offers amounting to a value of say, less than $5M in any one year be exempted from the prospectus requirements provided the employees are entitled to inspect the financial statements of the company and further provided that if the financial statements are audited then the audited statements must be made accessible to the employees. Obviously, details of the share plan should also be available for inspection by the employees.

A number of amendments are in train in relation to CLERP and it would be very useful for ASIC to prepare a policy statement as part of the explanatory memorandum to those amendments with a particular focus on the ASIC view on how those amendments may apply to employee share plans.

- **The 5% Limitation**

Subsections 139CD(6) and (7) of Division 13A of the ITAA prevent a share from being a 'qualifying share' where the participant holds more than 5% of the shares in the company or can exercise control over more than 5% of the votes at a general meeting. Small companies, particularly those with less than 20 employees, are very likely to experience difficulty in enabling all of the participants to obtain a qualifying participation because one or more of them are virtually certain to hold more than 5% of the shares or the voting rights. This rule also applies to proxy votes which gives rise to the clearly unintended application of the rule to say, the Chairman, Managing Director or Secretary of a company who have been designated to vote the proxies at a meeting (this may depend on the contemporanity of the acquisition of a share and the holding of the proxy rights but it is clearly an unintended consequence if it is applied to deny qualification).

I recommend that these rules regarding qualification be relieved so that the 5% limit is increased progressively as the company becomes smaller. For example, for between 50 and 100 employees, the requirement could be lifted to say 7½%; for 20 to 50 employees it could be lifted to say 10% and for less than 20 employees it could be lifted to say 25%.

See also my comments below regarding employee share buy-outs.

- **Only ordinary shares?**

Section 139CD(4) requires that all the shares available for acquisition under the scheme (ESOP) are ordinary shares. There is no definition of 'ordinary' shares and this alone provides difficulties where there may be more than one class of shares which are widely held. The consequence of the shares not being 'ordinary shares' is that the participation (in those shares) cannot be 'qualifying' (see above).

Ordinary shares in common parlance would embrace a bundle of rights which would usually include dividend, voting and winding-up rights. Whilst this arguably is not always necessary, the critical right in the context of small and medium companies is the voting right because the 'existing shareholders' would usually be most unwilling to give up their control even if they are prepared, as is often the case, to allow employees to participate in the profits of the company. I have been told on many occasions that the employees would be quite happy to hold a share which can appreciate in value and participates in profit without a voting right. Unfortunately, it is very likely that such a share would not be considered to be an 'ordinary share' and accordingly participation in such a plan could not be qualifying.

I recommend that the requirements of subsection 139CD(4) not apply to companies with less than 100 employees. Alternatively (but less desirably) for companies with less than 100 employees there be no requirement that voting rights be included in the bundle of rights attached to the relevant shares.

- **Loan Arrangements**

To encourage employees to take up shares it is very common for loans, usually interest free, to be provided to the employees. Further, to substantially remove the risk from the investment (particularly an investment in a small/medium company) the loans are often limited recourse or, where the shares fall in value, partially forgiven. The forgiveness of a loan raises the possibility of fringe benefits tax being payable and this appears to be inappropriate in the context of an employee share plan provided the amounts forgiven do not exceed the amount by which the shares have fallen in value since they were acquired.

I recommend that the forgiveness of an employee's debt in relation to the acquisition of shares under an ESOP be not subject to fringe benefits tax provided the amount forgiven does not exceed the amount by which the shares have fallen in value since the time they were acquired.

- **Franking Credits**

As mentioned above, limited recourse loans are a relatively common mechanism for ensuring employees are not at risk in relation to their investment. Unfortunately, recent changes to the dividend franking rules require the shareholder to be at risk in order for the dividends to be franked.

I recommend that the requirement for a shareholder to be at risk in order for dividends to be franked be removed in respect of shares acquired under an ESOP.

A similar but more complex issue arises in respect of the accounting for the cost of issuing shares under an ESOP. Whilst it is not currently a requirement under accounting standards applying to Australian companies, it is open for a company to charge its profit and loss account with its notional (or 'lost opportunity') cost of issuing shares. For example, if the shares have a market value of $2.00 but are offered to employees at say, $1.90, a company could record the $0.10 per share as a "cost" of issuing the shares. The accounting entry would be a debit to the profit and loss account and a credit to the share capital account. Unfortunately a credit to the SCA of this nature is deemed to taint the SCA which results in a debit to the franking account of the company as if a dividend had been paid. This consequence is horrendous for a company and is surely unintended in relation to an ESOP.

I recommend that a credit to the share capital account arising from recognition of a cost of issuing shares to employees not be treated as a tainting of the SCA.

- **Employee 'Buy-Out's'**

Whilst rarely seen in Australia, the acquisition (take-over)of a company by its employees is relatively common in the United States, Canada and the United Kingdom. However it will be recognised from a number of the comments made above that the taxation rules would work against such a useful economic outcome. Further, the maximum period of 10 years (by which time participation in an ESOP must be taxed under Division 13A) is overly restrictive in relation to employee buy-outs because the very nature of these transactions is the long term ownership of the company by the employees. It would be economically disastrous for the employees to have taxation forced upon them at the 10 year point merely because they are holding the shares irrespective of their inability (as would typically be the case in a small to medium company) to realise the value for those shares at that time. It would also seem likely that an employee buy-out would not constitute an employee share plan if the invitation to participate does not actually come from the employer (typically the impetus for a buy-out is a collective decision of the employees resulting in a offer to the existing shareholders often financed by an external financial institution).

I recommend that an employee buy-out be given recognition as an employee share plan for taxation purposes and the 10 year restriction in subsections 139CA (2)(d) and 139CB (1)(e) not be applied to shares resulting from employee buy-outs. See also the "5% limitation mentioned above.

Jon Kirkwood
Ernst & Young
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