Submission

Employee Share Ownership in Australian Enterprises

PREPARED FOR:
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1.0 INTRODUCTION

This paper has been prepared in response to a request for a submission on Employee Share Ownership in Australian Enterprises by the House of Representatives Standing Committee on Employment, Education and Workplace Relations.

The paper draws on the following research conducted by Remuneration Planning Corporation Pty Ltd (RPC) over the last seven years.

- 1992 Employee Share Plan Report (1992 Report)

  A survey of 288 organisations on their employee share plan practices and detailed analysis of 95 individual employee share plans. This was the first detailed empirical study of employee share plan practice in Australia.

- 1995 The Employee Share Plan Report (1995 Report)

  An analysis, through publicly disclosed information, of the share plan practices of Australia's top 350 listed public companies together with analysis of other contemporary employee share plan practices in Australia.

- 1997 Employee Share Plan Handbook (1997 Report)

  An analysis, through publicly disclosed information, of the share plan practices of Australia's top 350 listed public companies considering in particular Post Division 13A (ITAA) issues.

- 1999 Director & Executive Remuneration Report (1999 Report)

  A similar analysis to the 1997 report. Contains both detailed employee share plan practices in Australia's top 350 public companies , but also an analysis of executive remuneration levels.

In addition, reference is made to a report commissioned by RPC in 1993 from Vince Fitzgerald on "**Savings Through the Firm - Employee Share Plans - Context, Role and Implications for Enterprise Performance, Savings and Taxation**" (Fitzgerald Report).

This paper summarises and highlights the data available from each Report relevant to the key issues being considered by the Committee. Selected extracts from the Reports are appended. Full copies of all reports are available on request.

The paper also presents anecdotal evidence and independent commentary on the key issues considered, based on RPC's data and experience gained in the market place. A brief profile of RPC and an indicative client list is appended by way of background (Refer Appendix 7).

Finally, comments on impediments to employee share ownership plans (ESOPs) in Australia are presented.

By it's nature, this Submission is only a summary of the key issues and is presented as a guide to the major issues under consideration.

RPC would be pleased to brief the Committee directly on ESOP practice in Australia and / or conduct specific research on behalf of the Committee.

2.0 WHAT IS AN ESOP?

There are 5 broad types of Employee Share ownership schemes functioning in Australia under the generic term of ESOP.

They are distinguished by their leverage exposure and method of funding the entitlement to shares in an employer company by an employee.

The plans can be categorised as follows:

1. FULLY PAID SHARE OWNERSHIP PLANS FUNDED BY LOANS FROM THE EMPLOYER COMPANY (“LOAN PLAN”)

   That is, fully paid shares are either bought on market or through a new issue and paid for by loans from the company. The employee only receives a benefit if the loan is repaid and the capital value of the shares plus dividend exceeds the loan value plus accumulated interest if any.

2. FULLY PAID SHARE OWNERSHIP PLANS FUNDED BY NEW ISSUES OR SUBSCRIPTIONS MADE BY THE EMPLOYER OUT OF PROFIT SHARE, REMUNERATION SACRIFICE, BONUS (SHORT & LONG TERM)(“SUBSCRIPTION PLAN”)

   Subscription type plans are the style of plan contemplated under the terms of Division 13A (ITAA), whereby taxation concessions are made available to employers / employees to encourage ownership of employer shares.

3. PARTLY PAID SHARE PLANS

Under partly paid share plans an employee, usually at a senior executive level, is issued with shares at a predetermined price but only paid to a small portion of their value. Fully paid shares result when the unpaid portion is paid by either the company or the employee.

4. OPTION PLANS

Options give an employee the right to acquire a share in the future at a predetermined price, subject to terms and conditions, as set down in the offer. Fully paid shares are issued on the "exercise" of the option.

5. REPLICATOR SHARE PLANS

Replicator share plans, as the name would suggest, replicate a "normal" ESOP and are used where the company cannot issue "real" shares. These plans are also known as "phantom", "synthetic" or "shadow" share plans.

Within the 5 main categories there are a multitude of variations and it is under this "total banner" that the term ESOP or ESOS is used in Australia.

All types of plan have a place in corporate Australia, although our preferred model is a "three pillars" approach of Subscription Plan, Option Plan and Replicator Plan.

3.0 INCIDENCE OF ESOPS

Data collected and reported in our various reports over the last seven years give the Committee an insight into the ESOP practices in Australia's largest companies.

Key highlights from these reports include:

3.1 1992 Report (Refer Appendix 1)

In 1992 46% of companies surveyed had an ESOP (Refer Attachment 1.1)

Plan incidence was highest amongst listed companies included in the survey: 75% had an ESOP (Refer Attachment 1.2)

The bulk of securities issued (number and value) were issued to general employees (Refer Attachment 1.3).

3.2 1995 Report (Refer Appendix 2)

69% of the companies in the Top 350 companies had an ESOP. Options were the dominant plan (59.51%) (Refer Attachment 2.1, 2.2)

Only 58 companies had an ESOP which involved more than 50 employees and / or more than 2% of capital (Refer Attachment 2.3)

3.3 1997 Report (Refer Appendix 3)

74.4% of listed companies has an ESOP (Refer Attachment 3.1).

Only 18.5% of companies with ESOPs had ESOPs that applied to greater than 50 employees and / or greater than 2% of capital (Refer Attachment 3.2).

3.4 1999 Report (Refer Appendix 4).

89.4% of the companies in the Top 350 companies had an ESOP. Options were the dominant plan (54.2%) (Refer Attachment 4.1)

3.5 Anecodatal Evidence and Commentary

We would estimate that less than 25% of all public companies have taken advantage of the taxation concessions embodied in the legislation affecting employee share plans introduced in December, 1995.

This is due to a number of reasons, including:

- The company is not aware of the advantages of the taxation concession; or
- The company is aware of the benefits but doesn't believe the cost of design, implementation and administration is worth the effort; or
- Employee share plans are fighting a list of competing priorities and the company hasn't got around to it yet; or
- The company has an existing employee share plan and will redesign the plan when existing commitments expire; or
- The company doesn't think employee equity participation will benefit the business in any way.

Of those public companies with an employee share plan, more than 80% would only offer participation to Senior Executives, and less than 10% would have meaningful, all employee plans in place.

Notwithstanding, there is a sea-change underway and momentum will continue to build if ground rules are left unchanged or improved.

4.0 IMPACT OF ESOPs ON WORKPLACE RELATIONS AND PRODUCTIVITY

4.1 1992 Report (Refer Appendix 5)

More than 50% of companies surveyed were pursuing objectives of either employee ownerhship / partnership and motivation. (Refer Attachment 5.1).

About 75% of companies surveyed felt that these objectives were either achieved or partly achieved. (Refer Attachment 5.2).

A comparison of the performance of companies with an ESOP and those without, indicates that companies with an ESOP perform better (Refer Attachment 5.3).

4.2 1995 Report (Appendix 6)

Companies with an ESOP outperform those companies without an ESOP on all measures (Refer Attachment 6).

4.3 Anecdotal evidence and commentary

The Australian data supports similar conclusions drawn from a study of 640 Canadian pubic companies on the Toronto stock exchange in 1987. In that study, companies with a share plan significantly outperformed companies without on measures of profitability and productivity.

Our client work also supports the view that ESOPs are introduced in pursuit of improved employee relations and productivity. These are the most common objectives articulated in the planning stages of an ESOP implementation project.

A theoretical model for the achievement of these objectives can be illustrated below:

[Not reproduced]

5.0 IMPACT OF ESOPs ON THE ECONOMY

5.1 Fitzgerald Report

The major potential impact of ESOPs on the economy is through their impact on national savings.

At page viii in his report Fitzgerald states that:

"Australian Employee Share Plans (ESPs) hold perhaps $1 to $3 billion of assets now (around half of that is net worth), but annual saving through them probably does not exceed $100 million.

Given a clear path forward set by secure policy, expansion over the 1990s of ESP coverage, predominantly via new style ESP vehicles, from the present 5 per cent of employees to around 15 per cent is felt to be a conservative scenario.

That scenario suggests saving through these vehicles rising to 0.7 per cent of GDP over that time frame, with a net impact of perhaps 0.5 per cent of GDP on national saving, and assets rising over this decade to perhaps $15 billion (today's dollars), and continuing to grow - very worthwhile contributions to national saving flows and savings assets".

The general conclusions espoused by Fitzgerald in his report are reprinted below:

"The general conclusion of this paper is that employee share plans, particularly the new generation plans which have emerged in the last two years or so, have a potentially valuable effect on performance of Australian enterprises and potentially valuable effects in generating net additional flows of voluntary financial saving – indeed saving in a form providing capital largely for equity in Australian enterprises, small and medium sized enterprises which (it has been argued) have found it difficult to obtain equity: along with other medium to long term investments.

It is not desirable, however attractive the attributes of these plans are, to make ad hoc provisions in their favour, including confirming for the new generation vehicles (including "save only" implementations), the relatively favourable treatment presently applying, without articulating a general policy approach into which this treatment fits. Articulating such a policy approach applying to a defined class of savings vehicles will give all involved greater clarity and certainty on which to plan.

As argued in the National Saving Report, it is therefore important that the Government explicitly address the general issue of encouraging voluntary private saving, including through appropriate taxation treatment, and against the general framework of principles so developed, resolve the issues currently before government in the present review of ESP's."

These conclusions are as relevant today as they were in 1993.

6.0 CASE STUDIES

A couple of practical illustrations may give the committee a flavour of the application and use of ESOPs in Australian companies.

- Enterprise Agreements and Employee Share Plans.

  As far as we are aware, only two companies, Qantas and Westpac have incorporated employee share plans into their enterprise agreements. Neither company has used share benefits as a trade-off for cash. David Jones are contemplating linking share rewards as part of their enterprise agreements, but are intimidated by the number of Unions they confront.

  We are aware of other major corporations with ESOP / Enterprise Agreement issues on the agenda.

- How should share benefits be paid for ?

  This is the vexatious question all companies face. If a share reward is provided "free" to an employee it is not valued, yet it has a diluent impact on shareholders.

  The funding of shares, eligibility, performance hurdles and vesting restrictions applied, by a selection of companies, under both Tax Deferred and Tax Exempt ESOPs is illustrated below:

  [*pages 8 and 9 are confidential*]

7.0 IMPEDIMENTS TO ESOPs

7.1 <u>Taxation</u>

Division 13A of the Income Tax Assessment Act (ITAA) introduced 2 concessions to encourage ESOPs being:

(i) $1,000 tax free grant: or
(ii) 10 year tax deferral.

However, certain conditions which need to be met to access the concessions do act as an impediment to participation.

These include:

1. The shares must be ordinary shares

This prevents many private companies who wish to maintain control of the business from implementing ESOPs because they would prefer to use a special class of share that enables them to offer equity participation to employees while maintaining control.

2. 5% Rule

This rule prohibits any one employee controlling more than 5% of the voting capital of the company. Again this prevents many small companies from using ESOPs as a way, for example, of transferring ownership over time to employees.

3. 10 year Rule

Tax is deferred for a maximum of 10 years and then becomes payable even if the shares held are not sold. This can act as a disincentive to retain shares obtained under an ESOP.

7.2 Regulatory

The major regulatory constraint on ESOPs is under the Corporations Law, in particular the provisions governing the need for a prospectus and the Managed Investment Scheme provisions.

These provisions are intended to protect investors where money is raised through public shares offers, but can also cover the limited offer of shares under ESOPs.

The problem is associated with the cost of compliance and given the nature of most share offers to employees under ESOPs, the need to protect employees as investors is not great.

Some relief is available to employers under various policy statements and class orders but this relief tends to favour publicly listed companies.

7.3 Other Considerations

In Australia, there is a misconception that ESOPs must be limited to no more than 5% of a company's capital. Many US corporations have and encourage much higher levels of participation.

To encourage ESOPs in Australia as a key component of performance pay and workplace productivity improvement, further incentive for general employee participation should be considered, including:

- Group plans for private companies to minimise administration costs;
- Some element of investment diversification should be considered for prudential reasons; and
- Portability of entitlement across employers should be contemplated.

8.0 WHAT QUALIFICATIONS DO RPC HAVE TO COMMENT ON ESOPS?

Remuneration Planning Corporation Pty Limited ("RPC") is a dedicated consulting practice, established in 1987, whose principle mission is to design, implement and manage total remuneration solutions, including Employee Share Plans for Australia's major companies.

A timeline of selected RPC achievements over the last decade include:

1988 Unique Advanced Option Contract implemented by RPC in conjunction with AIDC privatisation.
Employer sponsored subscription style share plan established in Australia with ATO approval.

1989 RPC develops first Australian adapted, US style s.401(k) share/savings plan for Du Pont Australia Limited.

1990 to 1992 RPC involved in a series of ESOP structure developments to overcome tax uncertainties arising out of constantly changing income tax, FBT and CGT regulations.

1993 RPC writes ACTU guidelines to employee share plan participation entitles "Handle with Care".

1993 to 1994 RPC involved in extensive lobbying with all parties on method of encouraging employee equity participation in Australia, leading to legislation changes embodied in Division 13A.

1995 to Present RPC markets the benefits of Division 13A Employee Share Plans to Australian Public Companies, with increasing success.

1999 Shadow of uncertainty placed over ESOP's by ATO's embargo on ESOP rulings in April, 1999. RPC lobby for lifting of embargo.

RPC's consultants have collectively the largest experience base of ESOP application in Australia. Our team has consulted to more than 500 Australian corporations in our 12 years of operation, including many of Australia's largest companies.

Our total approach to the design, documentation, compliance, implementation and on-going management of Employee Share Plans places us in a unique position in the advisory industry in this narrow and highly specialised field.

9.0 CONCLUSIONS / EXECUTIVE SUMMARY

1. The incidence of ESOPs is high amongst listed companies and low in unlisted companies.

2. Of the companies with an ESOP, many limit their ESOPs to a small number of employees and / or a small % of their capital.

3. Overall, the % of the workforce covered by ESOPs in Australia is low.

4. Data supports that ESOPs are introduced in pursuit of improved workplace relations and productivity.

5. Anecdotal evidence supports the positive role of ESOPs in pursuit of these objectives.

6. Data consistently supports the view that companies with an ESOP perform better.

7. ESOPs can also have a positive impact on the economy by increasing national savings.

8. Certain tax and regulatory impediments to ESOPs do exist and policy in these areas should be reconsidered.

[*appendices: pages 14–29 have not been reproduced; pages 30–32 are confidential*]