Chapter 2

Structure and operation of employee share schemes

What are employee share schemes?

2.1 Employee share schemes provide a means for employees to obtain shares in the company where they work and thus become part-owners of their employer's business.[1] They are used:

> …to align employee's interests with those of their employer so that employees benefit directly when the company does well and employers benefit through having a more committed and motivated workforce. An employee share scheme provides employees with a financial interest in the company they work for through the distribution of shares in that company.[2]

2.2 Several terms are used to describe these schemes or plans: employee share ownership schemes or plans, employee share schemes, etc. For the purposes of this report, the term 'employee share scheme(s)' is used (excluding direct quotations).

2.3 Most employee share schemes have the following features:

- shares or rights are acquired at a discount rate to the market value;
- disposal is allowed after a qualifying period of employment or having met performance hurdles;
- employee forfeits shares or rights upon resignation or termination of employment if this occurs before the expiry of the qualifying period; and
- there is 'usually a period between the grant of the shares or rights and the time at which employees can first realise' their value.[3]

General and executive employee schemes

2.4 Employee share schemes can be categorised in a number of ways depending on the variable and the purpose, thus providing different costs and benefits.[4]

2.5 One distinction is between the narrow-based schemes offered to company executives and general schemes for a broad range of employees. Evidence suggests that most benefits are accrued in companies with schemes that are offered more

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1 Australian Employee Ownership Association, *Submission 4*, p. 1.

2 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, p. 6, http://www.treasury.gov.au/documents/1559/PDF/consultation_paper.pdf (accessed 15 July 2009).

3 Taxation Institute of Australia, *Submission 10*, p. 2.

4 CRA Plan Managers, *Submission 8*, p. 5.

broadly, that is, also to ordinary employees.[5] Companies might set aside a percentage—five to 20 per cent—of their share capital to be issued to employees.[6]

2.6 With general employee schemes, there is little or no cost to the employee, risk is low and the design of the scheme simple. These schemes are offered to develop employee affiliation with the company rather than to provide financial rewards, which is why maximising employee participation is important.[7] Generally, schemes offering shares rather than options or rights 'are preferable for general employees, because they are less dilutive and provide a clearer alignment of value and benefit'.[8]

2.7 Executive schemes are a 'key strategic remuneration tool' linking remuneration to company performance and encouraging retention of key executives. Executive schemes aim to reduce the risk of 'short term actions at the expense of long term health of the company'.[9]

2.8 The Financial Sector Union observed that non-executive employees appear to have 'wide share holdings in minimal amounts', with 'far deeper share holdings being held by executives'.[10] A European study, surveying employee schemes in large European corporations, found that on an individual basis, a non-executive employee owner averaged €26,338 compared to €7.5 million for each executive. Top executives held 40 per cent of the capitalisation, compared with the non-executive employee owners holding 60 per cent.[11] Men were twice as likely as women to participate, potentially due to job segregation. Education also plays a role, with participation increasing with the level of education.[12]

Other categories

2.9 Plan types can also be categorised by their tax treatment into qualifying exempt or deferred schemes or non-qualifying employee loan and replicator schemes.[13] The qualifying schemes can be broken down further into share and option schemes. Loan participation plans operate in companies that do not have available

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5 See for example Hay Group, *Submission 15*, p. 3.

6 Remuneration Strategies Group, *Submission 11*, p. 11.

7 Hay Group, *Submission 15*, p. 3; Remuneration Strategies Group, *Submission 11*, p. 7.

8 Deloitte, *Submission 30*, p. 3.

9 Hay Group, *Submission 15*, pp. 4–5.

10 Financial Sector Union, *Submission 22*, p. 2.

11 Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 18.

12 European Foundation for the Improvement of Living and Working Conditions, 'Financial participation of employees in the European Union: Much ado about nothing?', Background paper, 2007, p. 20.

13 Replicator scheme is one which does not utilise shares but is based on performance rights and paid out as ordinary salary or wages. Remuneration Strategies Group, *Submission 11*, p. 11.

shares, such as joint ventures or franchises, where investments are made in other than the employer's shares. Option schemes are often provided for senior management.[14]

2.10 Replicator schemes refer to schemes that offer benefits that 'replicate share ownership but do not involve the acquisition of shares or rights'. They are used when the employer company is unable or unwilling to offer equities in the company. These schemes typically 'aim to provide the benefit at market value to avoid payment of tax' and funded through a low or interest-free loan or salary sacrifice arrangement.[15]

Operation

Establishment

2.11 There are three ways to structure an employee share scheme: the employer can issue shares directly to employees; or shares are issued to a trust; or the scheme can operate through a third party plan company.

2.12 If the shares are not issued directly to employees, they are usually provided to a trust that holds the shares on behalf of the employees. Trusts may be set up to administer the various conditions that apply to a scheme and to manage small share holdings and registry costs effectively.[16] Trusts reduce the number of entities subject to taxation, focus taxation liability on the beneficiaries of the schemes and are eligible for tax deductions.[17] Trusts are said to 'offer many advantages' particularly 'in the context of the neglected unlisted "SME" sector'.[18]

2.13 The third structure is administering a share scheme through a third party plan company. This arrangement provides flexibility regarding the source of shares, that is, shares can be acquired on market or new shares issued by the company. Third party plan companies 'will generally not be entitled to claim a deduction despite the accounting requirement' of expensing the value of share and option grants.[19]

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14 Remuneration Strategies Group, *Submission 11*, pp. 7, 9.

15 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 24.

16 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, p. 8.

17 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 20.

18 Brash Solutions, *Submission 21*, p. 1.

19 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, pp. 19–20.

Share offer

2.14 Once the scheme has been established, the employer makes an offer to its employees to participate. The employee may be given shares, rights to shares, or securities related to shares.[20] The offer outlines the terms of participation, including the conditions for holding the shares and the vesting of them—for example length of service, performance and debt repayments—and the number of shares and their cost (if any). If the employee accepts the terms and conditions, shares or rights will be allocated to his or her account, to the trust or through other arrangements.[21] Generally, shares are held in trust 'for three years or restricted from trade for a similar period'.[22] When the employee has met all the conditions, the shares are fully vested and the employee acquires a right to transfer the shares out of the scheme or can agree to be paid out of the scheme, obtaining the value of the shares.[23]

2.15 In issuing shares, company directors are required to act 'in accordance with their duties under general law and statute', including acting 'in good faith in the best interests of the company', and issuing shares for a proper purpose. For example, to establish an employee share scheme that 'substantially benefits employees at the expense of the company' could be in breach of their duty to act in the interest of the company as a whole and the different classes of shareholders.[24]

Funding and cost

2.16 There may be a cost involved in obtaining shares. Shares can be funded through contributions from wages and salary, performance bonuses, profit or other financial awards, or through a bank loan either from the employer or a third party.[25] Funding generally involves 'some financial contribution from the company'.[26] The company is permitted to assist employees financially to obtain shares at less than market value, at low interest or for free if they are given under an employee share

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20 Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, p. 6.

21 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

22 Financial Sector Union, *Submission 22*, p. 2.

23 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

24 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 12–14. Duties arise out of the *Corporations Act 2001*.

25 Australian Employee Ownership Association, *Submission 4*, p. 1.

26 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, p. 5.

scheme that has been approved in a general meeting of the company, and, if applicable, by the parent company.[27]

2.17 Shares can also be obtained through a salary sacrifice arrangement. Employees can salary sacrifice up to the $5,000 limit to purchase shares 'through subscription plans that also allow for the deferral of tax for a period of up to ten years, thus increasing their shareholding'.[28] The employee is eligible to 'derive any capital gains on the shares as a discount capital gain and only pay tax on 50 per cent of the nominal gain'.[29] Expanding broad share ownership could be encouraged through salary sacrifice arrangements, including employers providing free matching shares for every share purchased by the employees.[30]

2.18 A scheme is likely to pay out a departing member in a company 'that placed a high value on employee ownership and did not want to see the employee's stake in the business diminished when employees leave the company'.[31]

Rights of employee shareholders

2.19 Employee shareholders have 'a range of statutory and equitable remedies' available to protect their interests. The Corporations Act provides that employee shareholders may call an extraordinary general meeting if they hold at least five per cent of the votes that may be cast at a general meeting or constitute at least 100 members. However, their capacity to influence the conduct of business is considered to be limited because employee shareholders generally hold a very small minority of the company's shares.

2.20 Courts may impose a range of orders if a company's affairs are not conducted in the interests of the members as a whole or are discriminatory against a member or members. Further, 'if employee shareholders are recognised as members of a particular class, they may be afforded the statutory protections offered to class right holders', including regarding challenging a variation or cancellation of shares.[32]

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27 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 6–7.

28 Financial Sector Union, *Submission 22*, p. 2.

29 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 24.

30 Institute of Chartered Accountants, *Submission 16*, p. 4 and PriceWaterhouseCoopers, *Submission 5*, p. 2.

31 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

32 Ingrid Landau and Ian Ramsay, 'Employee share ownership plans in Australia: the corporate law framework', Employee Share Ownership Project, University of Melbourne, March 2007, pp. 17–19.

2.21 Mr Rod Masson, National Director, Policy and Communications, Finance Sector Union, noted the benefits of employees owning shares in their employer company: as both employees and shareholders, employees are able to take their concerns to the broader group of shareholders, including concerns that may have an effect on the overall company performance. He particularly noted the social responsibility and industrial matters.[33]

Reasons for and benefits of establishing an employee share scheme

2.22 Three structural characteristics that influence the presence of employee share schemes in a company include centralised human resource function; company growth over the preceding 12 months; and the composition of the workforce.[34]

2.23 A University of Melbourne study on employee share schemes in Australian listed companies noted that the most popular reasons for establishing employee share schemes were: showing that the company values its employees; allowing employees to share the financial success of the company; and aligning employee and shareholder interests.[35]

Benefits for employers

2.24 For the employer, employee share schemes may be a vehicle for changing the workplace culture and creating common goals;[36] the employer may wish to use the scheme to plan retirement or succession;[37] or the company may wish to increase the existing capital.[38]

2.25 A survey found that Australian employers lose an additional $20 billion every year because of increased staff turnover (by 5 per cent) due to skills shortage and ageing population. Turnover rate was an average of 18.5 per cent. Long-term incentives (LTIs) such as employee share schemes 'assist in the retention of employees', meaning that the company can afford to invest on training of its employees, which in turn 'results in better qualified employees and a more productive and profitable business'. Remuneration Strategies Group noted that employee share

33 Mr Rod Masson, *Proof Committee Hansard*, 27 July 2009, p. 65.

34 Ingrid Landau, Richard Mitchell, Ann O'Connell, Ian Ramsay and Shelley Marshall, 'Broad-based employee share ownership in Australian listed companies: Survey report', April 2009, p. 2.

35 Ingrid Landau, Richard Mitchell, Ann O'Connell, Ian Ramsay and Shelley Marshall, 'Broad-based employee share ownership in Australian listed companies: Survey report', April 2009, p. 1.

36 Australian Employee Ownership Association, *Submission 4*, p. 2.

37 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

38 Australian Employee Ownership Association, *Submission 4*, p. 1.

schemes should be seen as part of the human resources management as they 'assist in the attraction, motivation and retention of employees'.[39]

Increased productivity and profitability

2.26 One of the main reasons to establish an employee share scheme is to increase the company's productivity and profitability through increased worker productivity. A recent study concluded that companies with an employee share scheme or a similar scheme (broad-based stock options, profit sharing and employee participation) 'demonstrate higher performance across a number of parameters':

> …companies that embraced any one of these four approaches experienced a 4% gain in productivity, a 14% gain in return on equity, a 12% gain in return on assets, and an 11% gain in profit margins (controlling for other factors).'[40]

2.27 Employee share schemes appear to be more successful in companies where the majority of employees participate in a scheme and own 'a significant part of the company'.[41] Schemes are said to provide incentives for employees to obtain further experience and skills.[42] Evidence indicates that employees with 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'.[43] For example:

- In the US, companies with an employee share scheme had improved their productivity by approximately 3.5 per cent annually in comparison to companies without a scheme. In amongst the companies with a scheme, the most successful had high levels of employee participation through a variety of formal and informal arrangements;
- In Japan, productivity in companies with an employee share scheme increased by 4–5 per cent, the effect taking 3–4 years to manifest; and
- Another study concluded that companies with an employee share scheme had a return on assets 2.7 per cent higher than those without a scheme for each year of a four-year study and a cumulative total return 6.9 per cent higher then the average for non-scheme companies.[44]

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39 Remuneration Strategies Group, *Submission 29*, p. 17.

40 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, pp. 8–9.

41 Employee Ownership Group, 'Frequently asked questions on ESOPs', www.employeeownershipgroup.com.au/default.asp?id=43 (accessed 7 July 2009).

42 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 9.

43 Australian Employee Ownership Association, *Submission 4*, p. 5.

44 Australian Employee Ownership Association, *Submission 4*, p. 5.

2.28 Employee participation is said to be greater where there is union involvement.[45]

2.29 However, some studies have shown that shares will not make all employees work harder. Instead, they may choose to '"free-ride" off the efforts of other employee shareholders', and that the 'rewards for increased productivity will be diluted by the number of shares held by non-employees'.[46] Another study claimed that companies with employee ownership 'tend to invest less, take fewer risks, grow more slowly, create fewer jobs, have worse free cash flow problems, and exhibit lower labour and total factor productivity relative to otherwise similar companies'.[47]

Increased flexibility and fairness

2.30 In addition to increased profitability and productivity, employee share schemes have been found to advance flexibility and fairness in the workplace. They broaden the range of remuneration options and provide a competitive advantage in the labour market:

> They offer employers greater control over cash flow, allowing them to offer non-cash remuneration and manage their cash distributions in line with the business cycle. Finally, [schemes] provide employers with an excellent mechanism for succession planning, an issues which has proven particularly challenging for small and medium-sized family-owned businesses.[48]

2.31 To reap these benefits, there is a need for employee share schemes to be 'extended widely to ordinary workers rather than concentrated at the top levels of management'.[49]

2.32 Other benefits said to flow from employee share ownership include promotion of innovation and science particularly in small and medium unlisted companies, new industries and start-up companies.[50]

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45 Klaas Woldring, *Submission 2*, p. 3.

46 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 3.

47 Cited in Jarrod Lenne, Richard Mitchell and Ian Ramsay, *Employee Share Ownership Schemes in Australia: A Survey of Key Issues and Themes*, Employee Share Ownership Project, University of Melbourne, 2005, p. 15.

48 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 9.

49 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 4.

50 Ann O'Connell, 'Employee share ownership plans in Australia: The taxation law framework', Research Report, Employee Share Ownership Project, University of Melbourne, March 2007, p. 5.

Benefits and risks for employees

2.33 For employees, performance bonuses and incentive payments contribute to their savings.[51] Employee share schemes can complement the superannuation system, for example by providing access to finance prior to retirement, with employees having more direct control over the scheme and developing a different class of equity.[52] Companies with broad-based schemes are 'significantly more likely to have structures for communicating directly with employees'.[53] They are also more likely to offer better treatment for workers. Executive compensation appears to be lower in companies with an employee share scheme than in those without.[54]

2.34 Employee share schemes have been criticised for 'concentrating risk, for duplicating superannuation and for being regressive'. The risk has become evident during the global financial crisis, with many employees having lost their life savings when their employer company has collapsed. Mr David Hetherington noted, however, that the schemes are no more risky than other equity because the risk does not arise out of the employee share scheme structure. The employees have 'better information about the outlook of the company and a greater ability to influence its performance'. As with any assets, 'excessive concentration in a single asset is a risk' and according to Mr Hetherington, this could be managed by companies providing an annual consultation with an independent financial advisor.[55]

51 Australian Employee Ownership Association, *Submission 4*, p. 2.

52 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 10.

53 Ingrid Landau, Richard Mitchell, Ann O'Connell, Ian Ramsay and Shelley Marshall, 'Broad-based employee share ownership in Australian listed companies: Survey report', April 2009, p. 2.

54 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, pp. 11–12.

55 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 11.