Appendix 3

Overseas schemes

United States

1.1 The United States (US) has some 25 million employee owners with some €1,000 billion in assets.[1] Schemes exist in 'practically every industrial branch', from large, publicly traded firms to small, closely held companies.[2] Companies offer multiple schemes and employees participate in more than one scheme. Approximately 15 per cent of the workforce participate in some form of employee share scheme.[3]

1.2 The US legislation provides employee share trusts a special status which has led to a great increase in employee ownership.[4] Dr Klaas Woldring submitted that the fiscal and legislative measures make it 'attractive for both companies and employees to invest in employee ownership'. The measures facilitate the raising of loans from financial institutions for setting up a scheme and buying shares for employees, with loans repaid tax free from company profits and share dividends.[5] The growth has also been attributed to the better performance of companies with schemes.[6]

1.3 In the US, stock options for taxation purposes are categorised into two types: non-statutory, which are taxed under general principles of compensation and income, and statutory options.[7]

Non-statutory schemes

1.4 In non-statutory schemes, options are taxable upon grant if there is a readily ascertainable fair market value; if not, they are taxed at exercise. Subsequent gains are treated as capital gains, and taxation 'may be deferred if there is a substantial risk of forfeiture. Compensatory income can be converted into capital gains, and if done within 30 days of acquiring the option, the difference of the value and employee

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

2 Dr Klaas Woldring, *Submission 2*, p. 2.

3 Remuneration Strategies Group, *Submission 29*, p. 28.

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

5 Dr Klaas Woldring, *Submission 2*, p. 2.

6 Remuneration Strategies Group, *Submission 29*, p. 28.

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

contributions is taxed as ordinary income; on disposal, the excess is taxed as capital gain.[8]

Statutory schemes

1.5 Statutory schemes are plans approved by shareholders in order to grant employees options to purchase shares. Statutory schemes have two types of plans: incentive stock options (ISOs), often limited to key employees; and employee stock purchase plans (ESPPs), granted to all employees. In both types, the employer is generally not eligible to claim deductions, and both the employer and employee are subject to 'stringent reporting requirements'.[9]

1.6 Under ESPPs, there is no tax on the grant or exercise of a right. Any discount is taxed as ordinary income upon disposal of the right. Further gains are treated as capital gains. Discount can be 15 per cent at most but the shares cannot be sold within two years from the grant and one year after they are transferred. An employee's voting power or value of employer's stock must not exceed five per cent. Employers usually use payroll deductions to pay for the shares.

1.7 Similarly to ESPPs, taxation of ISOs occurs upon disposal, with gains treated as a capital gain. The part of the value exceeding $100,000 is treated as ordinary income. An employee's voting power or value of employer's stock is limited to no more than 10 per cent.

1.8 The three main employee ownership schemes in the US are Kelso or employee share ownership plans, the 423 plan and the 401(k) plan.

Employee share ownership plan

1.9 The employee share ownership plan (ESOP) or Kelso plan is the most popular employee share scheme type in the US, with 11,400 ESOPs and equivalent plans in existence, involving 13.7 million employee owners who held some €700 billion in assets in 2006.[10] ESOPs are leveraged share purchase instruments which enable employees to buy into their employer company over a period of time, on average over 3 to 5 years. It works in the same way as a corporate takeover. It can be used to

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8 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraph 3.

9 Information in this section is from The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 5–8.

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

finance the expansion of a company's capital base.[11] Employees can purchase shares using pre-tax income and third-party loans.[12]

1.10 In an ESOP, the company establishes a trust. If it is funded through loans, the company can deduct up to 25 per cent of payroll for repayments of principal, with interest payments fully deductible. If the scheme is not funded by a loan, up to 15 per cent of payroll is deductible for principal repayments. Further deductions may include dividends if they are 'used to repay an ESOP loan or paid directly to workers'. Employees do not pay income tax as the shares are acquired by the trust but any gains outside the trust are subject to capital gains tax (CGT). 'If over 30% of an unlisted company's shares are sold into an ESOP trust, CGT is deferred for as long as the proceeds are continually reinvested in domestic (US) securities'.[13]

423 Plan

1.11 The 423 Plan is an employer share only scheme.[14] It is similar to ESOP, with the main difference being that the employees hold their shares personally, not through a trust. Employees can acquire shares or options at a maximum 15 per cent discount, with CGT payable upon disposal of the shares. The 423 Plans are more common in public companies.[15]

401(k)

1.12 The 401(k) schemes are set up for retirement savings such as superannuation.[16] They are funded out of remuneration, with shares in the employer company and other listed companies purchased through profit shares, salary sacrifice and matching employer contributions. The legislation requires partial investments in non-employer equities to spread the risk.[17]

1.13 The Australian Employee Ownership Association considered 401(k) important to the share scheme discussion in Australia for a number of reasons. Firstly, its financing is closer to Australia's typical unleveraged scheme than ESOP. Secondly, it is very effective in increasing worker ownership. While smaller than the ESOP,

11 Australian Employee Ownership Association, *Submission 4*, p. 3.

12 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

13 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

14 Mr Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 79.

15 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

16 Mr Martin Morrow, *Proof Committee Hansard*, 27 July 2009, p. 76; Mr Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 79.

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

401(k) still has about 2,000 participating plans with two million employees who own an estimated US$250 billion.[18]

United Kingdom

1.14 In the United Kingdom (UK), there are four types of employee share schemes. Two of them must be offered to all employees that meet the qualification requirements; the other two can be offered to selected employees. The schemes generally require an approval of Her Majesty's Revenue and Customs (HMRC). Income tax and national insurance are payable upon exercising the option to buy shares at discount.[19]

1.15 The two main schemes are share incentive plan (SIP) and Save As You Earn (SAYE) scheme. The other two main schemes are the company share option plan and the enterprise management incentive scheme.

Share incentive plans

1.16 The share incentive plan (SIP) offers employees four classes of shares: partnership, free, matching and dividend shares. Companies must set up a trust to hold the shares.[20]

1.17 Using pre-tax income, an employee can acquire up to £1,500 in partnership shares annually.[21] In addition, an employee can be given up to £3,000 in free shares, provided they have been held in the scheme for five years. If the employee keeps the shares in the plan until they are sold, no CGT is payable; if the shares are sold after leaving the plan, CGT will apply.[22]

1.18 With post-tax income, an employee can acquire two matching shares for each partnership share held (up to £2,500 annually).[23] Taxation depends on how long the shares have been in the plan: similarly to the free shares, there is no income tax if the

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

19 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 15–16.

20 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 22.

21 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 13.

22 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 17–18.

23 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 13.

shares are held more than five years. Free and matching shares can be forfeited if the employee ceases employment, and performance conditions can be included.[24]

1.19 In addition, an employee can reinvest tax free up to £1,500 of dividend shares in the employer company. Dividends 'used to buy dividend shares are taxed when the shares are withdrawn from the plan'.[25] In total, employees can receive up to £7,500 worth of shares each year in three components of £2,500 each. However, not all employers offer all three components but can choose the one(s) most suitable for their employee base.[26]

1.20 The employer is eligible for tax concessions regarding the 'costs of offering free and matching shares and the costs of offering partnership shares where this exceeds employee contributions'.[27]

1.21 A 2005 reform enabled people to roll their benefits out of the scheme into an individual savings account or a self-invested pension.[28]

Save As You Earn scheme

1.22 The Save As You Earn (SAYE) scheme differs from the SIP scheme in that the employee may acquire options to buy shares rather than actual shares. It has similar characteristics as the SIP plan but no risk for the employee: 'if the share price doesn't exceed the exercise price of the options, the employee can simply take the accumulated savings in cash'.[29]

1.23 Options are offered by the employer company at up to a 20 per cent discount to the current share price.[30] Employee savings accumulate in a special interest-bearing tax-free account.[31] The employee contributes a monthly post-tax sum for an agreed period (3, 5 or 7 years) after which the government makes a co-contribution tax-free, based on the duration of the saving. The funds can be used to exercise the options or

24 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 19 and 21.

25 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 13.

26 Mr Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 79.

27 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 13.

28 Mr Geoff Price, *Proof Committee Hansard*, 27 July 2009, p. 80.

29 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

30 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

31 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraph 24.

taken as cash. Upon exercising the options, the shares become liable to CGT.[32] Employees must enter into a special savings contract with a financial institution to buy the shares at the end of the fixed term. There is no income tax on grant of the options, and no tax when employees use their savings to buy shares.[33]

1.24 The employer may impose restrictions including that shares must be sold upon cessation of employment. Savings-related schemes may also require that the employees have been employed for up to 5 years to be eligible to participate in the scheme.[34]

Company share option plans

1.25 Company share option plans (CSOP) allow companies to choose the employees and directors to whom to grant options up to a maximum value of £30,000 at grant. No income tax is payable at grant or if the option is exercised after three years but before ten years after grant. On disposal, CGT is payable unless the gains fall below the annual exempt amount. Participation excludes employees owning more than 25 per cent of the company. Employers may place restrictions on the disposal of shares.[35]

Enterprise management incentive scheme

1.26 Enterprise management incentive schemes are designed for small companies and exclude businesses in banking, insurance and farming. Employees can be granted options over shares up to £120,000 in value. There is no tax on the grant or exercise of the option unless the exercise price is less than the market value, in which case the discount is subject to income tax. When sold, shares are subject to CGT from the date of grant.[36]

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32 David Hetherington, 'Employee Share Ownership and the Progressive Economic Agenda', Per Capita, 2009, p. 14.

33 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 23–24.

34 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 23 and 26.

35 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 27–31.

36 The Treasury, 'Reform of the taxation of employee share schemes', Consultation Paper, Appendix D, paragraphs 32–33.

European Union

1.27 Employee ownership in European Union countries has grown in the last ten years. Because of the late uptake, Europe is behind the United States in the prevalence of the schemes.[37]

1.28 According to the 2008 European Union survey regarding employee ownership in large European corporations, the equity of the 9.1 million employees working in these corporations mounted to €240.2 billion, a decline of 15 per cent from the previous year.[38] The average equity held by each of the 8.2 million European employee owners (excluding top executive) is €15,933.[39] Most of the shares are 'still held by top executive employees rather than ordinary employees (39.5 per cent for executives compared to 60.5 per cent for common employees).[40] Only around 12 per cent of European employees 'receive income from some form of profit sharing scheme'.[41]

1.29 On average 85.1 per cent of the European corporations provide some type of employee ownership, with all large Finnish and Irish corporations having these schemes. France has the highest number of companies with broad-based schemes (86.5 per cent), with the European average being 51.9 per cent.[42] The survey concluded that 'employee ownership is strongly involved in companies' governance and strategy.[43] European corporations renew or launch new schemes regularly, with a 3–4-year-old plan considered old.[44]

1.30 According to the study, employee ownership is going to double within the next 5–10 years in Europe, from the current 9.1 million employee owners to

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37 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 12.

38 European Federation of Employee Share Ownership, 'Economic Survey of Employee Ownership in European Countries in 2008', http://www.efesonline.org/Annual%20Economic%20Survey/2008/Presentation.htm (accessed 13 July 2009).

39 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 31.

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

41 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. 27.

42 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 25.

43 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 16.

44 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 13.

16 million, or from the current 28.2 per cent of employees in large European companies to 40–50 per cent. Capitalisation is estimated to rise from 2.6 per cent now to 4–5 per cent.[45] The study concluded that 'it seems highly probable that most European countries will increase to 40 per cent or more employee owners within the next 5–10 years'.[46]

1.31 There is 'a growing disparity' between countries such as France and the UK that have had schemes for a long time and countries 'with the least developed financial participation policies and institutions'. It is said that European countries need to share information and models and exchange experiences on best practices. Remuneration Strategies Group explained:

> 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.[47]

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45 European Federation of Employee Share Ownership, 'Economic Survey of Employee Ownership in European Countries in 2008', http://www.efesonline.org/Annual%20Economic%20Survey/2008/Presentation.htm (accessed 13 July 2009).

46 Mr Marc Mathieu, *Economic Survey of Employee Ownership in European Countries in 2008*, European Federation of Employee Share Ownership, Brussels, May 2009, p. 29.

47 Remuneration Strategies Group, *Submission 29*, p. 29.