

# sharing the gains

Without significant reform and intergovernmental co-operation, the future of employee share ownership in Australia looks uncertain.

**Story** Melissa Wilkinson

The concept of employee profit sharing is not particularly new, as schemes to align employee and shareholder interests were introduced as far back as the 18<sup>th</sup> century. With skin in the game, the theory suggests that employees are more likely to take a long-term view of the business and think about company issues from a shareholder's perspective. This should, in turn, lead to better outcomes for the business and its stakeholders.

Employee share ownership (ESO) schemes have operated in Australia since the 1950s but they're still relatively new here compared to other countries like the United States and United Kingdom. They weren't formally addressed in Australian federal legislation until 1974 and, since then, a range of complex tax and corporations law measures have been introduced.

Over the last few years, there has been quite a push to get the relevant tax legislation changed so that any increase in the value of shares acquired under a tax-deferred share plan is taxed as capital gains not as income

## ESO TAKE-UP

The quantitative data measuring the growth and take-up of ESO schemes in Australia has been patchy to date, but it does indicate that overall employee share ownership is gradually increasing.

According to figures from the Australian Bureau of Statistics, the proportion of employees in 1979 who received shares as an employment benefit was 1.3 per cent. Over the 10-year period between 1989 and 1999, the percentage of full and part-time employees taking part in some kind of employee share scheme grew from 2.4 per cent to 5.5 per cent. By 2004, 5.9 per cent of a total of 481,000 Australian employees

held shares as a form of employment benefit.

In the last few years when firms struggled to find good staff in the midst of a skills shortage, the schemes attracted quite a deal of interest. Companies in sectors like financial services turned to them as strategies to retain and motivate top performers.

There are two main types of employee share schemes: executive remuneration schemes designed to drive senior management performance and broad-based schemes designed to drive employee engagement across the business. The research to date indicates that executive schemes are the most common type of ESO scheme in operation.

A study by KPMG in 2003 on equity-based compensation schemes found that up to 80 per cent of listed companies

in Australia had introduced at least one type of ESO scheme, although it was not clear whether this included executive remuneration schemes as well as broad-based schemes. This is in contrast to private companies where the take up was less than 10 per cent.

## TAX BARRIERS

The current taxation concession regime under Division 13A of the *Income Tax Assessment Act* is commonly cited as one of the key roadblocks to further growth in ESO schemes.

There are two main types of plans under the current system. Under the tax-exempt

option, an employee can receive up to \$1000 worth of shares each year without paying any tax on them. Any growth in the value of the shares above \$1000 may be taxed at the concessional capital gains tax (CGT) rate.

The second option is a tax-deferred plan which is typically used by companies who want to issue larger bundles of shares. Under this option, an employee can defer the tax liability on these shares or options for a period of up to 10 years. The problem with the deferred plan is that it does not attract any CGT relief. Instead, employees must pay income tax, at their top marginal rate, on the full value of the shares at the date of exercise (options) or the date restrictions lift (shares).

For a plan to qualify for tax benefits under Division 13A, it must meet a number of prescriptive conditions. One important requirement is that at least 75 per cent of the employer's permanent employees of three years' standing must have been offered ordinary shares in the employer's company.

Under a non-qualifying ESO plan, employees will be taxed upfront at their marginal tax rate on the market value of the ESO benefit when it is received. However, according to John Day, director of Remuneration Strategies Group, there are other options.

"There are also non-qualifying ESO plans that are fully flexible, can be tax deferred and which allow the growth in share values to be taxed as concessional capital gain. The two winners of the ESO plan of the year award for 2009 (awarded by the Australian Employee Ownership Association) were non-qualifying plans and they have been enormously successful.

"Any valuation problems (with a non-qualifying plan) are overcome by consistently applying a simple valuation formula. Control is not a problem if it is managed through an independent plan trust. Dilution is an illusion because under the new accounting standards (AASB2), the share plan costs have been fully expensed in the accounts of the company."

The key area of concern from ESO lobby groups is that the current income tax legislation unduly favours the tax-exempt plan.

This plan receives more generous tax treatment as it can access capital gains tax concessions. As a result, more employers tend to adopt this type of scheme. The problem is that it involves restrictions on the amount of shares issued, so it ultimately limits the overall growth of employee share schemes in Australia.

Over the last few years, there has been quite a push to get the relevant tax legislation changed so that any increase in the value of shares acquired under a tax-deferred share plan is taxed as capital gains not as income.

Organisations like the Employee Ownership Group (EOG) have been vocal about trying to get changes made to Division 13A. The EOG group secretary Gary Scarrabelotti, says that Division 13A is both company and worker unfriendly.

"We've been lobbying governments since 2002 and we've often spoken with Ministers and Treasury officials about a range of problems posed by tax and corporate law for ESO schemes. At the moment, companies are restrained from implementing flexible and generous share plans because the legislation is highly inflexible and frankly unjust," says Scarrabelotti.

"Any growth in the value of shares in deferred plans should be taxed at the CGT discount rate instead of at the income tax rate. The legislation, as it presently stands, seems designed to rein in the spread of employee share plans."

Unfortunately, attempts to change the current taxation concession regime in the past have been limited. Thirty of the 45 recommendations put forward to an inquiry into employee share ownership in Australia in 2003 were rejected by the then federal government. The Australian Tax Office (ATO) seems to be reluctant to make changes to Division 13A because it wants to protect the integrity of the tax base and importantly, prevent an increase in tax avoidance.

#### **DISCLOSURE ISSUES**

The other key issue hampering the take-up of the schemes relates to the *Corporations Act* and the scope of the relief issued by Australian Securities and Investments Commission (ASIC). Other than in certain limited cases, offers of securities, including those under a share plan, require the issuance of a disclosure document such as a prospectus or a complying offer document.



The ASIC disclosure rules are in place because it needs to ensure that employees have enough information so they can make appropriate investment decisions.

There are some exemptions and relief available to issuers, but they're very narrowly defined. In reality, it means that only listed companies and very small unlisted companies can take advantage of them.

The disclosure rules make the implementation of ESO schemes difficult for private and unlisted companies because of the costs associated with issuing a complying offer document.

### PRIVATE AND UNLISTED COMPANY ISSUES

Andrew Clements, tax partner at law firm Mallesons, says that there are also two other ESO dilemmas for private and unlisted companies.

"The first one relates to the creation of a market when the securities are illiquid. This issue is complicated because there currently is a lack of co-ordination between the corporate and tax rules.

"The second issue relates to valuing the shares. You either need to get a registered company auditor to do a valuation or go to the Tax Office and get a ruling. Both options are time consuming and expensive and can

be a major impediment, particularly if you have to get regular valuations done when employees leave."

There are also issues relating to control for private company founders. For example, if a small company had a large employee share scheme in place, the owner could potentially lose control of the business if a block of employees chose to exercise their voting rights.

PricewaterhouseCoopers partner Gregory Will, who specialises in advising private businesses, says owners need to think carefully before going down the ESO scheme route.

"Once an employee becomes a shareholder, they're entitled to a lot of detailed financial information. This means that you need to run the company on a very transparent basis. For example, you can't have personal or tax-related items going through the business. You must have a strong shareholders' agreement in place and carefully manage expectations around the payment of dividends."

### LACK OF DATA

Ann O'Connell is special counsel at Allens Arthur Robinson and associate professor at the University of Melbourne's law school. As part of a ESO project funded by the Australian Research Council, she says that a lack of data is contributing to the challenges surrounding the take-up of the schemes.

"To date, there is only limited research available and much of what's been published doesn't clearly differentiate between executive remuneration and broad-based schemes. Without reliable independent data from bodies like the ATO and ASIC, it's impossible to assess whether the current public policy, law and regulation are appropriate for businesses and employees but the perception is that they are not."

O'Connell is hoping that the Government's focus on innovation will help increase its interest in making changes to the current tax and corporation laws.

"The Rudd Government has indicated it's committed to innovation so hopefully they'll see the current ESO legislation as a problem. We need to push the idea that the new economy needs these concessions to operate more effectively," she says.

### MARKET ISSUES

Another issue affecting ESO schemes at the moment is the state of the financial markets. Interest in broad-based schemes in particular has fallen as a result of the collapse in the sharemarket. Many investors have fled equity markets and turned to safe haven asset classes like cash. While it may be a good time for employees with broad-based schemes to reinvest at cheaper prices, there's unlikely to be widespread interest as the Australian economy moves deeper into a recession.

In terms of executive remuneration schemes in listed companies, Clements believes that in the current market, the design of many current equity-based schemes can create problems.

"Because of the poor performance of equity markets, it's becoming virtually impossible for executives who work in many listed companies to meet the hurdles required. It's very common for options to no longer be relevant at all. When markets drop, the schemes can become redundant in terms of motivation.

"The problem is that it's difficult to amend the terms of the existing options and performance hurdles. Attempts to review the hurdles to make them more relevant when market conditions are poor can be perceived as executive greed. Adjusting schemes to make them more relevant in a difficult market is a hard sell."

### FUTURE OF ESO PLANS

Under the previous federal government, employee share schemes were an area of policy reform and work was under way to examine the key barriers relating to the plans. As the Howard government was keen to try and promote greater employee share ownership in Australian workplaces, it set up a special promotional branch called the Employee Share Ownership Development Unit (ESODU).

In February 2004, the then Minister for Employment and Workplace Relations, Kevin Andrews, even announced a target of doubling the employee share ownership schemes in workplaces from 5.5 per cent of employees to 11 per cent by 2009.

Gary Fitton, spokesperson from the Australian Employee Ownership Association, says that this target will never be met without greater interest in reform from the government.

"The Howard government supported an Employee Share Plan Industry Liaison Committee which acted as a forum for these issues to be regularly fleshed out.



It would be great if this could be re-energised because ESO schemes are a powerful way to redistribute wealth in the economy. We don't need overly prescriptive legislation, just more interdepartmental co-operation to help standardise the different regulatory requirements."

The problem is that the Rudd Government has its hands full dealing with the aftermath of the global financial situation. ESO schemes have clearly fallen off the political radar screen and there are more pressing issues like the state of the country's health and education systems to address.

Part of the trouble with getting reform under way is that ESO schemes do not sit neatly within any one ministerial portfolio. They're reasonably dry as an electoral topic which makes them unattractive to a potential sponsor who's after a hot political platform on which to launch a debate.

The listed company sector is also unlikely to be a huge driver of ESO schemes in the near future. Those companies who are seeing value in broad-based schemes from an employee engagement perspective are

schemes which require at least three years' employment.

Agitation for reform from the Australian union movement is also unlikely. To date, there has been a general reluctance on behalf of unions to embrace ESO schemes. Unions have tended to regard them with suspicion, because of the schemes' scope to potentially erode existing collective bargaining relationships with management.

Deloitte Reward partner Jo Tropeano says that plans focused on executive remuneration will continue to be topical.


"There's considerable anxiety about how they're going to be used to reward performance in the future. How are they going to work in an environment with flat profits and a fluctuating stockmarket? They can be quite a lottery so that's why it will be important to get the metrics right. Plans must be calibrated to each company's business strategy.

"There will always be a clear need to align management's interests with corporate performance – but generic schemes will not be the answer. The metrics or hurdles

remuneration policies for firms in the financial services sector will be released soon. Companies will need to show that executive remuneration is aligned with shareholder's interests. This means that bonuses are likely to be paid in equity or options as opposed to cash.

"To date, there haven't been any rules around how to pay executives but the global financial crisis will cause greater regulatory change on this issue. Executive pay has been blamed as one of the factors that contributed to the crisis."

Although some lobby groups are trying to market broad-based ESO schemes as deferred employee wealth vehicles, Robinson is sceptical.

"Superannuation is a better option for long-term wealth creation because it diversifies an investor's risk and has better prudential controls. Importantly, it's also more effective from a tax point of view. In the absence of government support, the outlook for broad-based schemes in particular is pretty dim." 

## Interest in broad-based schemes in particular has fallen as a result of the collapse in the sharemarket

likely to persevere with them during the downturn over the next 18 months. However, those firms who haven't gained significant benefits so far are likely to sideline them in an effort to trim costs.

There are also questions being raised about whether the schemes are really appropriate as engagement tools for Generation Y employees. These younger workers like to change jobs every one to two years, which means that many are not eligible to take up shares in tax concessional

used in the schemes must be tailored for each organisation. We need to ensure that executives are getting the right rewards, in the right circumstances and for the right reasons. There are many situations in the past where this hasn't happened."

Michael Robinson, director at executive remuneration firm Guerdon Associates, says that reform in this area is under way.

"The Australian Prudential Regulation Authority has indicated that regulatory changes in regard to executive

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