



WEEKLY TAX BULLETIN

27 August 2004

ISSUE 36 ARTICLES

PRACTITIONER ARTICLES

[1522] ESOPs as business, financial and estate planning vehicles for business owners and employees

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Employee share ownership plans (ESOPs), qualifying as a tax-deferred or \$1,000 tax exempt employee share scheme under the qualifying provisions of Div 13A of the ITAA 1936, provide participating employees with an ownership stake in their company and an opportunity to reap the rewards emanating from that ownership.

ESOPs also provide the sponsoring employer with an invaluable source of new investment funding for the business, and a highly effective means of repaying geared lending arrangements undertaken by the Trustee of the ESOP.

Since the end of the 1980s, when the Federal Government legislated to restrict complying superannuation funds to a maximum investment of 5% of the issued shares of the sponsoring employer company, ESOPs provide the prime opportunity for the sponsoring corporate employer to invest in its own shares.

This article examines how qualifying ESOPs can be used as effective remuneration and incentive benefits for employees, and also provide valuable corporate finance, estate planning and succession planning opportunities, especially for current shareholders of unlisted, closely held companies.

Geared ESOPs

ESOPs operating by way of an administering trustee can borrow funds to buy company shares, thus removing the downside risk exposure from the participating employees. These ESOPs are referred to as *Geared ESOPs*.

The advantages to the employees of geared and ungeared ESOPs can be substantial. They can also serve as a vehicle for corporate finance which, if properly used, can provide tax advantages and corporate funding opportunities.

Benefits of ESOPs

ESOPs can provide a liquid trading market for shares that may otherwise be thinly traded, as they can allow current owners to sell their shares to employees in circumstances where there may be no other outside party capable or interested in acquiring the shares in the business. They can also become a means of enabling the current owners of the business to retain ownership in the hands of management (ie a management buyout) or other employees (ie an employee buyout).

Tax advantages of ESOPs

If the ESOP is geared or leveraged, which means that funds are borrowed from an external lender to buy out the current shareholders, the company can potentially obtain income tax deductions for not only the interest payments, but also repayments of the principal loan amount (refer ATO Interpretative Decision ATO ID2002/1074).

If properly structured, the ESOP can provide the seller of the shares with additional tax benefits ranging from total tax exemption of the capital profit made on the sale, to an exemption of 50% of the capital profit for shares held for 12 months or more.

ESOPs and financial planning

One reason that business owners, employees, financial planners and remuneration planners should take an interest in ESOPs, is that the implementation and administration of an effective qualifying ESOP can create tremendous additional opportunities for the effective use of other traditional estate and business succession planning techniques.

The qualifying ESOP can provide benefits to current shareholders by creating a means of disposing of part of their existing shareholding, and diversifying a portion of the shareholder's wealth, thereby creating money management opportunities for the financial advisor.

The success and potency of any ESOP is inextricably linked to the success and strength of the business, which itself is linked to the quality of the management team. The implementation of key person or executive benefit insurance plans can enhance the effectiveness of the ESOP, by providing additional funding benefits to the company by creating a sinking fund which can be used for repurchasing retiring executive and general employee shares. Qualifying ESOPs may also be used in conjunction with other non-qualifying employee share plans (eg loan plans) or other replicator share plans.

Qualifying ESOPs

While successive Australian Federal Governments have precluded employee superannuation schemes from a predominant investment in the sponsoring employer (ie no more than 5% of issued shares), qualifying ESOPs have no such restriction. Indeed, in order to access the legislated taxation benefits, the qualifying ESOP must only provide investments to employees of shares in their employer.

While the benefits of employee shareholdings are not necessarily tied to retirement, they can provide a substantial adjunct and supplement to employee's superannuation based retirement benefits.

In practice, a qualifying ESOP can operate alongside employees' superannuation-based investments and other geared property and equity investments. The elegance of the qualifying ESOP in this financial package is that employees do not need to gear their investments themselves and expose themselves to the dangers of geared financial downside risk. Importantly, \$1 worth of pretax remuneration investment by the employee (eg as a salary sacrifice or profit share) acquires \$1 worth of employer shares in a qualified ESOP. While the employee may win or lose on that investment,

they can never lose more than the dollar invested and have no loans to repay or interest commitments to meet from that investment.

ESOPs and superannuation

While qualifying ESOPs operate very much like complying superannuation funds, they are subject to different legislative requirements and have different taxation consequences. For example, ESOPs are not subject to a contribution tax or surcharge - which may tax up to 28.5% of employer superannuation contributions.

Like superannuation funds, there are ESOP plan documents that are required to set out all of the provisions necessary for qualification of the plan under the provisions of Div 13A. These qualifying conditions can include:

- the eligibility of the participants (eg no participant must have more than a 5% shareholding of the company);
- the shares must be ordinary shares of the employer and may be subject to restrictions on disposal for a minimum period (eg which is required for both \$1,000 exempt and deferred qualifying ESOPs); and
- they may require restrictions on sale (ie for the earlier of 3 years or termination of employee in the case of qualifying \$1,000 exempt ESOPs) or forfeiture conditions (ie in the case of qualifying deferred ESOPs).

Other non-qualifying ESOPs may not be subject to those qualifying ESOP conditions and may prove more effective - especially for small, closely held companies.

Like a superannuation fund, most qualifying ESOPs are administered by the establishment of a Trust. The Trustee has legal ownership of the shares and extends beneficial or actual ownership to the participating employees. The Trustee undertakes the fiduciary obligations of administering the plan fairly, responsibly, and according to the Plan rules. One or more individuals, usually employees of the employer, may serve on the Board of the Trustee and they will be responsible to the members for the proper administration of the ESOP.

Employer contributions to the qualifying ESOP made according to the type of plan, may take the form of an actual issue of company shares, cash or other property. Where cash or other property is contributed, those assets must be ultimately be used for the acquisition of shares or rights to shares in the employer.

Limits

While there are limits on contributions made by an employer to complying superannuation funds, there are no legislated limits to the level of contributions made to a qualifying deferred ESOP on behalf of Australian employees. Of course, qualifying tax exempt ESOPs are limited to the discount of \$1,000 per annum per employee. Limits for employer contributions to qualifying ESOPs are usually set by how much the company can afford, or in the case of salary sacrifice, how much the employees wish to have removed from their pre tax salary packages.

The only other limits which could apply are the anti-avoidance provisions of Pt IVA, in situations where the contributions are made for the predominant purpose of tax avoidance (eg so-called "cherry picking" plans or artificial schemes which were not made for the purpose of providing employees with equity or not made for the purpose of enhancing the capital of the company). As a general rule, qualifying ESOPs should be set up with the following characteristics:

- contributions must be paid to a trust which is established and administered for the exclusive benefit of the participating employees or their associates (eg dependents and other beneficiaries);
- participation in the qualifying ESOP should be available to a broad cross-section of employees (ie at least one share plan should offer shares to at least 75% of all permanent employees), although share rights may be issued selectively;
- benefits under the ESOP should be fair and reasonable - however, a variety of terms and conditions may apply depending on the types of employees concerned;
- qualifying exempt share plans must be completely non-discriminatory and uniform in their terms;
- ideally, the plan must be intended as a permanent and continuing program with proper communication of the terms of the plan to the participating employees; and
- the plan must be administered in compliance with general trustee fiduciary rules, ASIC requirements, ATO requirements and ASX requirements where the shares are listed.

To meet other requirements for the taxation benefits, and to meet the ASIC requirements, the shares held in trust must be applied exclusively for the benefit of employees and must never be able to be converted to the benefit of the contributing employer.

Estate planning benefits

Financial planners are well aware of the complex decisions facing the owner of a business in a later or transitional stage in their life or career. Qualifying ESOPs can provide an outstanding opportunity to assist these business owners in addressing and managing these life stage events.

While business owners are subject to CGT on any profits they make on sales of their shares, there are a number of taxation benefits which can arise depending on the circumstances surrounding their shareholdings. For example:

- shares held before 20 September 1985 will usually be exempt from CGT;
- an individual business taxpayer may be fully exempt from any CGT where:
 - the asset has been held continuously for 15 years;
 - the tax payer is at least 55 years of age; and
 - the CGT event happens in connection with retirement of the tax payer;
- there is a 75% reduction in the level of CGT where the asset was held for 15 years, it is an active business asset and the net value of the assets is \$5m or less;
- a capital gain up to a maximum of \$500,000 can be rolled into a superannuation fund or paid out as an ETP; and
- rollover relief from CGT is also available where the funds from the disposal of the active assets are rolled over into the acquisition of replacement active assets.

However, care must be taken in closely held private companies where the issue of shares results in an owner having control of the company by holding more than 50% of the shares.

Other benefits

The sale to the qualifying ESOP by the owner of the business can create significant liquidity for the shareholder and the estate. If less than 50% of the shares are sold to the qualifying ESOP, the founding shareholders can maintain control of the company, and transfer that control gradually to the participating employees in the qualifying ESOP.

However, even in the situation of a 100% employee buy-out, the founding shareholders and/or senior management can maintain effective control of the company by maintaining control of the trustee company as a subsidiary of the employer.

Tax benefits of geared ESOPs

Other benefits that can flow from the qualifying ESOP include the capacity of the sponsoring company to have the ESOP borrow funds, over which the sponsoring company can provide a guarantee, and the company can obtain tax deductible contributions to allow the qualifying ESOP to repay the loan. These tax benefits mean that the sponsoring company, the qualifying ESOP, and the employees participating in the ESOP have more money to service the debt and invest in the future of the company.

Succession planning

Family companies, which are closely held unlisted companies, can facilitate succession planning by family members and other suitable employees to enable founding shareholders to retire from the company and realise the true value of the assets which they have built up in the company business. This does not necessarily mean an immediate or entire disposal of all their shareholdings. This may be achieved gradually and managed to ensure that the business of the company endures and grows with the new employee and management shareholders.

The key point is that owners of businesses can retain as much control of the company as they view to be appropriate given the availability of new employee owners and the circumstances of the business.

Dissident shareholders

Qualifying ESOPs can also be a strategic mechanism for buying out dissident shareholders or assist in the settlement of a divorce, especially in the case of closely held, private, family companies. If there is a dissident shareholder, the remaining shareholders can potentially buy out an aggrieved colleague at a more favourable price given the CGT concessions and the potential for tax deductibility by the company of contributions.

Divorce and ESOPs

In a divorce situation where only one spouse is involved, and the other spouse has an entitlement to half of that spouse's shareholding, the same benefits can apply. That is, the spouse shareholder involved with the company can maintain their existing shareholding by having the former spouse bought out on a pre-tax basis, with benefits provided in the form of tax concessional capital gain.

Employee buyouts

Where existing employees are considered appropriate to become part of the business, which involves acquiring a substantial shareholding in the business, the leverage buyout through the qualifying ESOP can provide a highly effective mechanism for them to be provided with equity with substantial shareholdings in the company, without the need to seek finance independently from the business and the ESOP.

Owners of a closely held business may be concerned about the level of financial information which they divulge to employees participating in a qualifying ESOP. This concern varies and many business owners favour an "open book" approach to running their business. Other business owners prefer to filter communication of company performance into "operating profits", which represents those elements of corporate profitability over which the participating employees can exercise influence and control.

Potential pitfalls of ESOPs

While the benefits of an ESOP can be substantial, those benefits have to be weighed against the potential disadvantages.

One disadvantage can be in respect of the rather onerous fiduciary responsibility which the Trustee undertakes. Conflict of interest may arise where the Trustee is also an officer of the company. It is often thought more appropriate that an independent Trustee be retained and the administration of the ESOP be undertaken externally.

While the funding of the qualifying ESOP may provide outstanding opportunities for the company and the participating employees, most qualifying ESOP plans, especially for unlisted companies (but also for certain listed companies), involve the ESOP and the sponsoring employer in maintaining the market, to repurchase the shares from retiring, deceased or terminating participants. This financial obligation should be treated as a contingent liability on the balance sheet of the company. The shares may be reallocated to current or future employees and charged against their remuneration, and in that way, "clawed back". However, there is the potential and real debt obligation which the company should provide for and disclose.

Share valuation

The shares in the qualifying ESOP have to be properly valued. This is an issue especially for unlisted companies. It is critical and necessary under the provisions of Div 13A ITAA 1936 governing ESOPs that the valuation be performed by a "qualified person" who is a registered company auditor and not a director, secretary or employee of the company.

Impact on Balance Sheet

It should also be noted that any guarantee for repayment of the loan provided by the sponsoring company will have an impact on the balance sheet and will effect the capacity of the company to obtain other funding for other general business needs.

These disadvantages are counterbalanced where:

- the funds may have been used to invest capital back in the company - which will minimise any debt or exposure as a guarantor;
- the debt should be easy to retrieve, due to the tax deductibility to the company for repayment of the debt; and

- the attribution of the contributions and shares acquired as part of the employees' pre-tax remuneration (ie as part of fixed pay and short or long-term incentives).

Conclusion

As demonstrated above, qualifying ESOPs can offer outstanding benefits and contributions to business, estate and succession planning. They have the potential to provide highly effective corporate finance strategies. They have the potential to provide solutions to resolving dissident shareholder matters, without needing to resort to oppressive actions against minority shareholders, which can result in costly, protracted and wasteful litigation.

These benefits are compounded by the potential tax benefits which the owner obtains from selling his or her shares in the form of the current CGT concessions.

Qualifying ESOPs can create an important ownership mind-set in participants. This ownership enables employee shareholders to directly benefit from their efforts and from the initiative in their employer.

In many other instances, qualifying ESOPs allow companies to survive, remain local and benefit the communities they operate within. The understanding of these unique benefits to business owners and employees will make ESOPs, both qualifying and non-qualifying, an invaluable financial planning technique, and a vital mechanism for business owners struggling to realise the value of their businesses in their later years, and to successfully deal with resultant succession planning and estate planning issues.