

The benefits of EMPLOYEE OWNERSHIP

As part of the 2008 Federal Budget, the Federal Government announced new measures aimed at reducing the potential taxation liabilities for some Employee Share Ownership Plans (ESOPs). The new measures are expected to encourage more companies to implement ESOPs. By **Manda Trautwein**

ESOPs HAVE LONG been recognised as an effective tool for motivating and incentivising staff by providing a mechanism for employees to become shareholders in the company. Only time will tell if the Treasurer's proposed measures can encourage a greater uptake of ESOPs. What is clear however is that Australia continues to lag behind its international counterparts in its embracement of such schemes.

It has been estimated that one in ten Australian businesses run some form of employee share ownership plan (ESOP). While ten per cent may seem like a high proportion, it is important to look at the different types of ESOPs implemented by these businesses. According to a study conducted by the Department of Workplace Relations' Employee Share Ownership Development Unit (ESODU) only four per cent of businesses have a broad based ESOP (open to at least 75 per cent of employees), which means that the majority of Australian ESOPs are targeted at executive employees only. Furthermore, the majority of ESOPs are found in publicly listed companies; only eight per cent of private companies surveyed by ESODU had an ESOP.

By comparison, the US General Social Survey in 2006 found that 17.5 per cent of the private workforce in the United States held shares in the company for which they work through an ESOP and 9.3 per cent held options. Moreover, a survey of European Union member states conducted in 2000 by the European Foundation found that 31 per cent of organisations with over 200 employees had an ESOP, 52 per cent of which were



Manda Trautwein, Director, VMC Global

broad-based (open to over 50 per cent of employees).

International comparisons must, however, be treated with care as ESOPs can often be defined in a different manner from country to country, similarly the scope of each survey may differ. What is clear, however, is that Australian companies appear to be slow on the uptake of ESOPs. With a workforce of approximately 10 million, a large proportion of Australian employees may be missing out. Furthermore, a significant number of companies are failing to realise the potential business benefits associated with ESOPs.

A recent study has found that companies in which employees own equity have a competitive advantage in terms of

productivity when compared with traditionally owned businesses. The June 2007 study, conducted by the Employee Ownership Foundation at the City University in New York, has found that in terms of sales per employee, companies with an ESOP enjoyed a US\$44,500 advantage which equates to an annual sales advantage of almost US\$9 million for a 200 employee firm.

Productivity aside, there are a number of other reasons why a company may wish to implement an ESOP including:

- Providing a reward or benefit for high-performing staff
- Increasing employee alignment with shareholder interests
- To ensure delivery of objectives
- To provide a staged succession plan for the current owners; and
- To improve recruitment and retention strategies.

With so many reasons to implement an ESOP the question arises: why are Australian companies slow to embrace ESOPs in comparison to their international contemporaries?

One answer offered is the lack of awareness surrounding ESOPs. In 2004, ESODU found that 49 per cent of business owners were unaware that there is no requirement to be listed on the stock exchange in order to utilise an ESOP. Moreover, only 23 per cent of business owners were aware that tax exemptions are available for certain broad-based ESOPs.

Many experts, however, believe that the reason behind the lack of enthusiasm for ►

ESOPs lies in the legislation governing Australian ESOPs. Currently there is no specific legislation for ESOPs, their governance falls under the *Corporations Act 2001*, taxation laws and the regulations set out by the Australian Securities and Investments Commission (ASIC).

According to Gary Fitton, president of the Australian Employee Ownership Association (AEOA), there are "major defects in the ESOP legislative provisions" in Australia. A number of barriers to ESOP implementation have been identified, including:

- Under the *Corporations Act* any company making an offer to over 20 people or for over \$2 million may be required to issue employees with a prospectus, including audited accounts (unless afforded relief under Policy Statement 49, see below). This may not pose a problem for large listed companies, but for smaller unlisted companies this disclosure requirement may be onerous, costly and thus prohibitive
- Under ASIC Policy Statement 49, companies using ESOPs for purposes other than fundraising may be relieved from the full disclosure requirements. In this situation, employees are however, restricted to collective ownership of a maximum of five per cent of the voting shares in the company at the time of issue. This restricts small companies from using an ESOP as a mechanism for succession planning
- Those companies looking to enable their employees to have access to tax exemptions or tax deferrals are restricted to offering ordinary shares or rights in

respect to ordinary shares in the company. As such, wholly-owned foreign subsidiaries or small companies in which the owner does not want to surrender control prior to exiting the business cannot benefit from tax deferral or exemptions on ESOPs; and

- Certain ESOPs that use employee share trusts are at risk of a double taxation liability. Under the current regime, a trustee or beneficiary of an employee share trust is provided with CGT relief when the employee becomes absolutely entitled to shares or rights held in the trust. CGT relief, does not, however, extend to shares held in the trust that the employee acquired by exercising rights that were previously acquired under an ESOP. In this situation both the employee and the trust may be liable for CGT.

As mentioned earlier, in the 2008 Budget, the new Government proposed to make amendments to the taxation laws in relation to ESOPs. As part of these amendments CGT relief will be extended to cover shares held in a trust that an employee has acquired by exercising rights previously acquired through an ESOP. This should eliminate the risk of double taxation. The Government hopes that the removal of this taxation anomaly will encourage more companies to take up an ESOP.

In spite of the Treasurer's proposed new measures to eliminate this double taxation of employee shares, many critics argue that legislative changes have not gone far enough. It is thought that the disclosure requirements laid out by ASIC pose the

biggest obstacle for small company ESOPs. AEOA proposes that the necessity to provide a prospectus for unlisted company ESOPs be lifted where comprehensive "downside risk protection" on the value of the shares is provided. While the prospectus requirement is aimed at protecting investors' interests, it could be argued that it is contrary to the objectives of the majority of ESOPs which are generally used to reward or motivate employees rather than raise capital.

Moreover, until companies are able to offer equity types other than ordinary shares or rights in respect of ordinary shares in ESOPs, and the restriction on employees owning more than five per cent of voting shares in the company is lifted in order for employees to be able to access tax exemptions or deferrals, many companies may still face barriers to ESOP implementation.

It appears that without meaningful legislative reform, Australia may continue to fall short in its use of ESOPs in comparison to other developed countries. ●

Manda Trautwein is a Director of VMC Global, a firm of chartered accountants that specialises in providing advice to companies across the full spectrum of corporate transactions. Tel 02 9235 3444 www.vmcglobal.com.au

The Australian Employee Ownership Association (AEOA) was founded in 1986 to promote employee ownership (or co-ownership) of the businesses where they work. For more details see www.aeo.org.au

Call Attache for a plain english guide to Next Generation software or a complimentary assessment. **1300 288 224**
www.attachesoftware.com



 **Attache**

Business grown up? Financial software hasn't!

ATT1_7501_7535