Employee Share Ownership Plans As a Business Succession and Exit Planning Tool

"Employee ownership is a different way of thinking about business. It targets long-term sustainability by recognising that employee/owners are more committed to developing innovative products and processes. The result is competitive advantage and lasting success – in good times and bad."

Sir Stuart Hampson, former Chair of the John Lewis Partnership

Employee Share Ownership Plans, or ESOPs, are a mechanism used to allow employees to own equity in the company they work for, with the express intention that they will **think and act like business owners**.

The primary objective is to create a structure with which employees' lifestyle and financial goals are aligned with business objectives. The result? A cohesive and committed team that is single-minded about working toward and sharing the benefits of a successful and profitable business.

ESOP companies have improved performance, higher profits and better staff retention than other businesses. The ability to attract, retain and motivate people to peak performance means being able to attract and retain business – and it is a major source of competitive advantage. In fact, it can mean the difference between success and failure.

ESOPs are used for several reasons:

1. Savings Vehicle - Most ESOP plans have a long-term focus (3 – 7 years), allowing employees to accumulate savings through acquiring and holding shares.

2. Participation – ESOP participants tend to experience a greater sense of community and involvement with the decision making process, leading to increases in employee engagement levels.

3. Succession planning - An ESOP can be an effective employee buy-out instrument when the owner(s) want to retire (or change their business direction) and need to sell.

4. Funding retirement – ESOPs can give founders the ability to extract cash prior to retirement.

In July 2015, the federal government introduced new measures to encourage and promote the use of ESOP's

"We have designed these changes to increase the international competitiveness of our tax system and allow innovative Australian firms to attract and retain high-quality employees in the globally competitive labour market"

Bruce Billson,
Small Business Minister (Australia),
January 2015

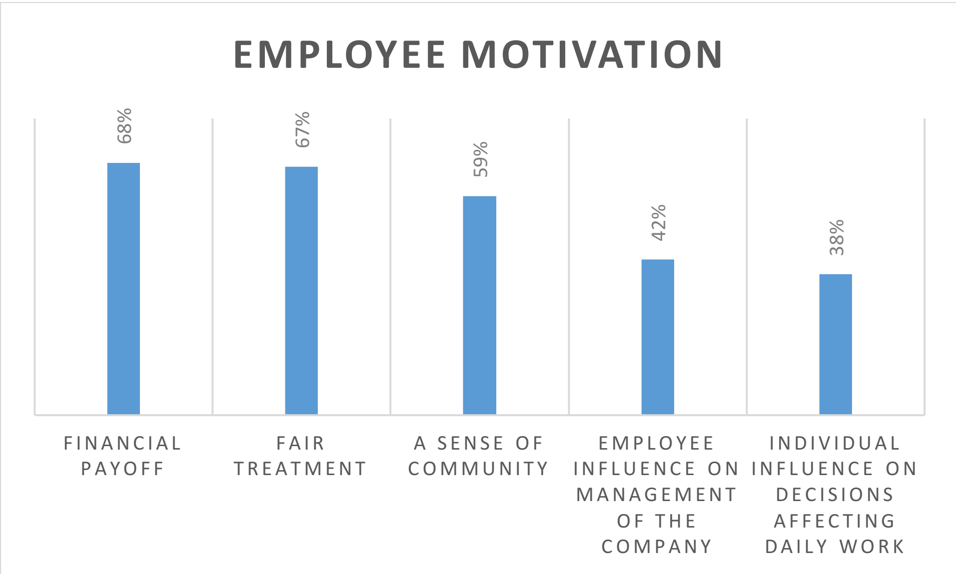
As part of the government's *Industry Innovation and Competitiveness Agenda,* new legislation was introduced in July 2015 to simplify Employee Share Ownership Plans and to encourage greater utilisation of ESOP's in Australia.

There's no better way to tune people in to creating shareholder value than to make them shareholders…I do know it gave our people more understanding and a sense of responsibility for what was going on in the company…in my view, it's a win-win."

David Thodey,
(former Telstra CEO),
May 2016

Why do workers get into ESOPs?

In a recent Melbourne University study a group of employees were asked certain questions and below is what employees ranked as the most important elements of an ESOP:



Source: Michelle Brown, Rowan Minson, Ann O'Connell and Ian Ramsay, ''Why do Employees participate in employee share ownership plans?' (Employee Share Ownership Project, Melbourne Law School, The University of Melbourne, 2011)

Academic research on the impact of ESOPs:

- ESOPs appear to increase sales, employment and sales per employee. *(Drs. Joseph R. Blasi and Doulas L. Kruse, School of Management and Labor Relations, Rutgers University).*

- ESOP companies that combine employee ownership with a participative management style **grow 8-11 percent per year faster** than they otherwise would have been expected to grow based on pre-ESOP performance. (*National Center for Employee Ownership. Harvard Business Review. September/October 1987).*

- Compared to 500 private non-ESOP companies, ESOP companies **paid better benefits**, had **twice the retirement income** for employees, and **paid higher wages** than their non-ESOP counterparts. *("Wealth and Income Consequences of Employee Ownership: A Comparative Study from Washington State." Kardas, Peter A., Scharft, Adria L., Keogh, Jim. November 1998).*

- Studies between ESOPs and productivity growth have found **greater productivity and profitability** in the first few years after a company adopts an ESOP. *(Dr. Doulas L. Kruse, School of Management and Labor Relations, Rutgers University. 1995).*

- The number of ESOPs in the UK increased by 10% during 2012 (*National Centre for Employee Ownership, February 2013).*

Deciding when to implement an ESOP:

Whilst the research undoubtedly shows an increase in employees looking for equity in the business they work for – Australia lags behind on the world stage in providing a mechanism to achieve this. According to recent research in both the United States and Europe a little over 30% of employees have some kind of equity interest in the business they work for; whilst in Australia that number is around 8%.

"Employees are keen to climb the ladder of equity – but someone needs to provide the ladder"

– Warren Buffett

Ladder of Equity

A simple mechanism to manage the transition through various stages is the issue – it is not simple, nor smart, to simply take an employee and provide them with equity – and thus the ladder becomes important:

1. Employee earnings: Earning (salary/wage/hourly rates, etc.) – this is where most employees start (and stay).

2. Income model: The first step on the ladder then is to boost that income and this is quite common – we often see companies paying bonuses, commissions on sales, incentives etc. to increase an employee's income.

3. Profit share - Most equity plans begin with this simple step and in fact many end at this step – simply providing a share of profits to employees is a great additional incentive as they are directly rewarded as a result of the financial performance of the company in the same way that a business owner typically would be.

4. Equity - Whilst there are many equity plans available our PPT provides a formal structured mechanism to incorporate stages three, four and five into any business succession plan – this allows employees to transition into an equity ownership position within the business they work for.

5. Control - often this step is never utilised though on occasion has substantial benefits in terms of succession not only of business management but also ownership. Ultimately control means that employees can be transitioned through the earlier four stages and end up in a position of control – this may be that they take over general management or CEO of the company, it may be that they end up with a seat on the board at some future date however this step is not to be rushed.

If managed correctly the ladder is a great methodology to identify opportunities to progressively transition employees to think and act like business owners and motivate key employees in the long term. Note however that the transition should be managed carefully with KPIs and performance criteria to proceed up the ladder – such plans can fall over without logical steps listed out for employees or where businesses miss steps trying to fast track progression.

Types of Employee Share Ownership Plans:

1. “Start-up” ESOP plans –

These plans have been introduced by the government as part of the government Industry Innovation and Competitiveness Agenda and are simple to set up and use. They also have significant tax advantages for participants:

- ✓ No up-front tax
- ✓ No tax at vesting
- ✓ No tax on exercise

Participants generally only taxed on disposal of shares or options and with 50% CGT discount.

The ‘Start Up’ ESOP plans are restricted to businesses that meet all of the following conditions, however:

- ✓ Not listed on public exchange.
- ✓ Aggregated turnover less than $50m.
- ✓ Less than 10 years old.
- ✓ Australian resident taxpayer.
- ✓ Shares must be offered to 75% of employees with more than 3 years’ service.

In addition, employees must also meet the following criteria:

- ✓ Must collectively own less than 10% of shares (and voting rights).
- ✓ Must be employed by holding company or subsidiary
- ✓ May only receive a 15% or lower discount on shares
- ✓ Must hold shares for at least 3 years

2. Premium Priced Option plans

The Premium Price Option ESOP model uses options instead of shares – and relies upon employees to work with the business owner(s) to build equity value. These plans are a simple and easy to manage model and sit outside the Employee Share Schemes (ESS) tax regime.

- ✓ The company issues options over shares to employees
- ✓ The options must be issued at a ***significant premium*** to the market value of the share (therefore NIL value at time of issue)
- ✓ The employee is taxed on capital account – CGT at marginal tax rates

3. Phantom share plans

Whilst these are not technically equity plans or an ESOP they are designed to provide similar benefits and features of an ESOP, normally in cases where issuing equity is not possible – either due to the ownership structure (such as a family discretionary trust) or where issuing equity might have adverse consequences (i.e. pre-CGT assets).

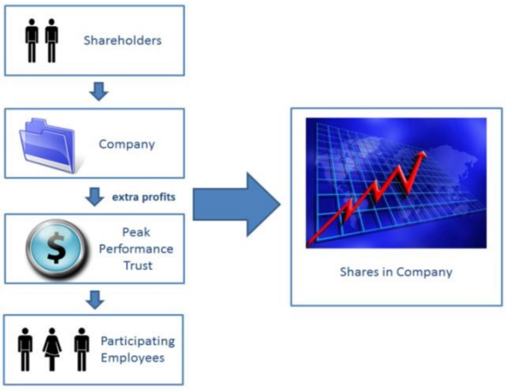
The plan is simply an agreement between the business owner/s and employee/s to pay a cash bonus equivalent to the increased equity value of the business, either at a certain date or upon a trigger event (normally sale of the business).

This type of payment is normally treated as a cash bonus and so employees must pay tax at marginal rates and also requires the company to have the cash available to make the payout.

Importantly, this payment may also trigger on-costs such as SGC, workers compensation, payroll tax etc.

4. Peak Performance Trust (PPT)

A PPT is an employer-created ESOP trust into which contributions are made on behalf of, and for the benefit of, the company's employees. The company commits to investing an amount of money into the trust on a regular basis, contingent upon participating employees achieving predetermined performance outcomes (often profitability targets). As the profits increase, so too does the contribution to the ESOP and the ability to purchase equity on the employer entity.



The Peak Performance Trust:	
✓	Is affordable for the business;
✓	Encourages ongoing profit improvement through rewards linked to performance;
✓	Is tax effective for both the business and participating employees;
✓	Reflects the values and culture of the business;
✓	Supports employee development;
✓	Rewards employees who make a substantial contribution to the business;
✓	Reflects different individual motivations;
✓	Does not result in additional administrative work;
✓	Is easily understood, controlled and managed;
✓	Is appropriate for both the long and short term;
✓	Complies with all current and likely Australian taxation and legal requirements;
✓	Assists in funding succession planning and new business opportunities;
✓	Helps to influence company culture;
✓	Gives the company a competitive advantage in recruiting, motivating and retaining high performance staff;
✓	Assists employees to achieve their financial and lifestyle goals.

Here’s how it works:

✓ The Employer will invite employees to participate in the PPT. Qualification is usually related to years of employment.

✓ A net profit benchmark and a percentage of profits above this benchmark to be shared to the PPT must be calculated. For example, the Employer could pay 25% of the net profits generated by the Employer over $500,000. If the Employer’s net profits for the year are $600,000, then 25% of $100,000 (i.e. $25,000) will be contributed to the PPT.

✓ The Trustee will use this contribution to allow employees to invest in shares in the Employer, by way of an interest free loan (the loan is a limited recourse loan to protect the downside risk for employees).

✓ Because the PPT has a share in the Employer, and Employees have a share in the PPT, increased profits will result in an increased value of each employee’s indirect share in the Employer. Further, because this is the only type of investment allowed under the deed, the equity value of the trust will always match the equity value of the Employer.

✓ Dividends will also be paid annually to employees in proportion to the units held.

✓ The only members allowed under the plan rules are employees – so if someone leaves they are automatically excluded and their units redeemed.

✓ Qualifying discounts are normally set up to govern the “disqualifying discount” – the amount that an employee is “penalised” if they “leave early.”

Client Testimonials

C-MAC Industries (Aust.)

Winner – 2012 ESOP of the Year Award presented by the Australian Employee Ownership Association.

The engagement of employees as owners has already seen an 18% hike in productivity at the plant.

"People are now saying 'us' instead of 'me' and asking, 'what do you want us to do?'. Job security is a key motivator at C-MAC and we do not want to lose employees with skills. There are now charts in the lunch room so everyone can see how the business is doing. The change has been truly unbelievable for all staff."

Steve Grylak, Manufacturing Manager – C-MAC Industries (Aust.)
Contact: steveg@cmac.com.au or (02) 9896 1806

LJ Hooker Commercial Central Coast

Winner - 2010 ESOP of the Year Award presented by the Australian Employee Ownership Association.

"Both financial services and property management referrals from employees participating in this scheme increased at a higher level than before. I put this down to their seeing value in contributing to the company's bottom line because they will share in the profit."

Wayne Dowling, Licensee - LJ Hooker Commercial Central Coast
Contact : wdowling@ljhc.com.au or (02) 43537700

National Personnel Group Mining

In many cases, the Succession Plus employee engagement model has been implemented in tandem with a Peak Performance Trust. This model is dedicated to unleashing the potential of SME's by providing the training and tools required to develop a workplace of "ownership thinkers" eradicating entitlement thinking with staff becoming active participants in their company's financial success:

Since kicking off our Succession planning program in May this year [2012], absenteeism has already dropped by at least one third! Overall, productivity is higher and our employees are taking more interest in the financial wellbeing of the business.

Bob Cameron, Managing Director - NPG Mining
Contact: robert.c@npgmining.com.au or (02) 4942 5798

'Have seen and recommend Succession Plus's Employee Engagement Seminar'

Michael Pascoe, Financial Journalist, Sydney Morning Herald

Frequently Asked Questions

1.	*What is my risk – what if the company owes money?*
a.	Employees who are members of an employee share plan are protected from any of the liabilities of the employer company and would not be liable for any debts or monies owed. Nor are they required to contribute to any losses incurred by the company.
2.	*Can I own the shares in a family trust or my self-managed Super Fund?*
a.	In most cases the answer is No - unfortunately many of the benefits are only available to employees and therefore the shares or options must also be owned by the employee in their own name.
3.	*Does being a member of an employee share plan affect the terms of my employment?*
a.	No - The share plan rules and qualifying conditions etc. relate only to the employee share plan and does not have any effect on the laws which govern your employment including any enterprise bargaining agreement, award or other arrangement.
4.	*If the share plan earns dividends from my employer do these come to me and if so, do I pay tax on them?*
a.	Yes - in all of the various structures the employee share plan would normally act as a "flow-through" device and in the case of the truss structure that is commonly used any given or distributions we see need to be passed through to the individual employees and at that point they would be taxed as part of the employee's individual income at marginal tax rates (in many cases dividends would include franking credits and these also are through to the employee).
5.	*What happens if I leave the company?*
a.	Except in very specific and unusual circumstances leaving employment would be disqualifying admit and in most of the plans this simply would mean that you are no longer able to the shares or options as you are no longer an employee. In many cases disqualifying events are also accompanied by disqualifying discount and so the value of your shares or options may be reduced, especially if you "leave early."
6.	*Am I now a director of the company or entitled to a seat on the board?*
a.	No - The employee share plan does not include any right to become a director of the company and in fact most employees do not want to become directors as this may well make them liable other areas. Typically, when a share plan becomes a majority owner in the company then the sheer plan may have the right to elect an employee to join the board of directors. This though is a matter for agreement between the employees and the current directors/founders of the company.
7.	*What information will I receive on the performance of the company?*
a.	Employee share clan members will always receive an annual statement that shows the number of units they hold and the underlying value of the shares in the company. The plan administrators will need to complete an annual valuation of the business as part of this process and that will always include a review of financial statements - most employers provide a summarised version of this information to ESOP members.
8.	*What happens if the company is sold?*
a.	In the event that the company is sold externally there are two possibilities:
	i) Members of the employee share plan are "forced" to sell at the same time as the founders and would therefore be paid out the value of their shares at the time of the sale. ii) The buyer decides to keep the employee share plan in place and continues to make contributions etc. in the same way that the original owners did.

For further information -

Succession Plus ESOP Overview

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