SUCCESSION+

Employee Share Scheme

A guide to offering staff a stake in your business

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What is an employee share scheme?

Employee share schemes – or ESS's – are a legal arrangement set up by businesses to allow their employees to own equity in the business. They are also known as employee share ownership plans, employee equity plans, employee options plans and phantom share plans.

They are suitable for small businesses through to the big end of town. In fact, many privately-owned businesses are surprised to learn they don't have to be listed on the Australian Securities Exchange to offer shares to their employees. There are different types of plans to consider depending on the size and structure of the business and what the owner hopes to achieve from offering one.

Why use an ESS?

Businesses offer ESS's to encourage their employees to think and act like owners. By offering an employee a stake in the business' success, they can serve to align the employee's personal financial goals with that of the business.

Unlike bonus schemes, incentives and commissions, which have a place in business but are short-term solutions, ESS's aim to maximise the value of the business over the long term by creating a team that is single-minded about working towards and sharing the benefits of a successful and profitable business.

Benefits of ESS's

ESS's are used for several reasons:

To offer employees a competitive renumeration package

Often, a remuneration package that combines a salary with long-term equity in the business is more attractive than a big up-front salary alone, and this can be an effective way for smaller businesses to compete with the salaries offered by corporate Australia.

Most ESS's have a long-term focus of three to seven years, allowing employees to accumulate savings through acquiring and holding shares. The employee can then benefit from both capital gain in the value of the shares and income through the payment of dividends. But as I tell my clients, it's important to explore what your employees or job candidates actually want.

To encourage greater participation and engagement within the team

As owners in the business, ESS participants have greater involvement in the decision-making process, which can make them feel more engaged with the work and its outcomes. Rutgers University research shows that to get the full benefits of employee ownership, it must be coupled with high-participation and performance policies, which include information sharing, teamwork and autonomy. Performance increases ranging from 7-23 per cent has been recorded at companies that get this mix right.

You may discover that income alone is not the predominant driving factor for many employees. Most of us are looking for a flexible and enjoyable work environment, professional development, a pathway to career progression, and being appropriately remunerated for our work. Start with your employees and develop a solution to remuneration and other benefits that will make them feel valued, motivated to contribute to the long-term success and sustainability of the business.

To encourage staff to stay in the business long-term

ESS's can be structured to match and deliver business goals and outcomes, the most common being employee retention. Some of the rules we have implemented for clients in the past include:

- A discount (or penalty) if an employee leaves the business 'early', where the total value of shares held is redeemed or the value is discounted based on time – leave after two years, you only get 20 per cent, after five years, 50 per cent, and so on.
- Bad leaver clause. If an employee does the wrong thing, they can lose the entire value.
- Vesting-style clauses where the value of the shares does not vest until after three years, for example.
- Ongoing contributions where the employer contributes to the plan to add more shares whilst the employee stays in the business.
- Stay bonus clause where a bonus for staying is paid into the plan – say after five years the employer adds a further 1 per cent of shares.
- A business can also share with employees the annual valuation of the business, showing the underlying increase in the value of their existing shareholding.

For succession planning

An ESS can be an effective employee buy-out instrument when founders want to exit the business. By providing a combination of financial harvest or selling the equity to remaining staff at a reasonable price, and stewardship, or enabling trusted key people to continue the culture, style and character of the company and making sure clients, suppliers and employees are treated well in the transition, founders can benefit from a more gradual, controlled and documented exit.

For funding retirement

ESS's can give founders the ability to extract cash prior to retirement by selling shares to employees. The employees benefit from the tax concessions associated with ESS plans and the founders avoid the market challenges and unpredictability of selling a business to an external buyer.

Ladder to equity

A word of warning: jumping straight into offering equity is almost always the wrong way to go about it. Considering a 'ladder to equity' approach is a much wiser strategy. It's a simple framework to manage the transition to employee ownership and it looks like this:

Step One: Employee earnings

This is where most employees start – and stay – earning a salary or wage. But it's often not enough to keep them long-term and does not include performance rewards. The next step is to consider other dollar-based incentives in addition to a salary or wage.

Step Two: Income model

This is about boosting income. To do this, companies will pay bonuses, commissions on sales and other incentives. It's an approach that is based on the individual and can sometimes create negative behaviors, such as discounting to get clients over the line, holding back orders to the next period to meet targets and unhealthy competition among staff. Having said that, many owners find success with this model, and I believe it has a place in business. But once mastered, the business may be ready to move on to the next form of incentive – profit share.

Step Three: Profit share

Most equity plans begin with this simple step and in fact many end here too. Providing a share of profits to employees as a bonus 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 the owner typically is. This step changes the focus from personal to team performance, and from profit alone to expenses as well, meaning employees are encouraged to think about cost savings and efficiency. It's an improvement on the first two steps, but is still short-term in its approach. Plus receiving a bonus tends not to be very tax effective for employees. The next step on the ladder can help address these issues.

Step Four: Equity

At this step of the ladder, a business is ready to consider an ESS. An ESS provides a formal, structured mechanism to combine steps three, four and five. This allows employees to transition into an equity ownership position within the business they work for and can encourage long-term strategic thinking. More importantly it can align employee behavior and goals with the business and owners. Later in this guide I have included the different types of ESS's that businesses can consider.

Step Five: Control

Often this step is never utilised though on occasion it can have substantial benefits in terms of succession, not only of ownership but also of business management. Ultimately, control means that employees can be transitioned through the earlier four steps and end up in a position of control. This may be that they take over general management or as CEO of the company, allowing the owner to reduce involvement and eventually exit or retire.

If managed correctly, the ladder is an effective way to progressively transition employees through the process of becoming owners, a way to gradually bring them around to thinking and acting like one. Note, however, that this transition should be managed carefully and with performance criteria to proceed up the ladder. Such plans can fall over without logical steps listed out for employees or where the business missteps by trying to fast-track progression.

Types of ESS

1. Start-up Plans

Introduced by the Government as part of its Industry Innovation and Competitiveness Agenda, start-up ESS plans are simple to establish and use.

They also have significant tax advantages for participants:

» No upfront tax

» No tax at vesting

» No tax on exercise

Participants are generally only taxed on the disposal of shares or options and with a 50 per cent capital gains tax (CGT) discount.

The start-up plans are restricted to businesses that meet all of the following conditions:

» Not listed on a public exchange

» Aggregated turnover of less than $50 million

» Less than ten years old

» Australian resident taxpayer

» Shares must be offered to 75 per cent of employees with more than three years' service

In addition, employees must meet the following criteria:

» Must own less than 10 per cent of shares and voting rights

» Must be employed by the holding company or a subsidiary

» May only receive a 15 per cent or lower discount on shares

» To hold shares for at least three years

2. Premium Priced Option Plans

The Premium Priced Option model uses options instead of shares and relies on employees to work with the business owner to build equity value. These plans are simple and easy to manage and sit outside the ESS tax regime. How they work:

» The company issues options 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, not income, and therefore typically at a lower rate – CGT at marginal tax rates

3. Phantom Share Plans

While not technically an ESS, they are designed to provide similar benefits and features of one, 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 (such as with pre-CGT assets).

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

This type of payment is normally treated as a cash bonus, requiring employees to pay tax at marginal rates and the company to have the cash available to make the pay-out.

Importantly, this payment may also trigger on-costs such as superannuation guarantee charge, workers compensation and payroll tax.

4. Deferred Tax Plans

As part of recent changes to ESS rules, the ability to introduce a tax-deferred plan has become popular among small to medium sized businesses.

Deferred taxation means the employee is taxed on the value of a share or right they acquire under an ESS – known as an ESS interest – at the market value of the 'deferred taxing point' as opposed to the value when they acquired the ESS interest.

Under current ESS rules, deferred taxation automatically applies to a qualifying ESS interest if either:

» There is a 'real risk' of forfeiture of the ESS interest under the scheme, or;

» The scheme is a qualifying salary sacrifice arrangement.

Deferred tax will not apply if the employee holds a beneficial interest in more than 10 per cent of the issued capital or 10 per cent of the voting rights.

The taxing point only arises when the right is exercised, and;

» There is no real risk that under the conditions of the scheme, the employee will forfeit or lose the share acquired on exercise (other than by disposing of it); and

» There are no genuine restrictions under the scheme on the share disposal.

For all ESS interests, the maximum deferral period under s 83A-120(6) is 15 years after acquiring the ESS interest.

5. Peak Performance Trust

A Peak Performance Trust (PPT) is an employer created ESS 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 profits increase, so too does the contribution to the plan and the ability to purchase equity.

The benefits of participating in a PPT for both the employer and employee can be considerable. This, unlike any other type of employee incentive tool, truly ties the employee's financial and lifestyle goals to the performance of the company. It is the ultimate 'golden handcuff' for your high-performing staff.

The Peak Performance Trust:

» Can be an affordable way to encourage ongoing profit improvement through rewards linked to performance.

» Can be tax-effective for both the business and participating employees.

» Is easily understood, controlled and managed without resulting in additional administrative work.

» Is appropriate for both the long and short term.

How the PPT works

1. The employer invites key employees to participate in the PPT, with qualifications usually related to years employed.
2. A net profit benchmark and a percentage of profits above this benchmark to be shared to the PPT is calculated. For example, the employer could pay 25 per cent of the net profits generated by the business over $500,000. If the employer's net profits for the year are $600,000, then 25 per cent of $100,000 (i.e. $25,000) will be contributed to the PPT.
3. The trustee will use this contribution to allow employees to invest in shares in the business.
4. Because the PPT has a share in the business and employees have a unit in the PPT, increased profits will increase the value of each employee's indirect share in the business. Furthermore, 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 business
5. Dividends are paid annually to employees in proportion to the units held.
6. The only members allowed under the plan rules are employees. If someone leaves, they are automatically excluded and their units are redeemed.
7. Qualifying periods are typically set up to govern the disqualifying discount or the amount that an employee is penalised if they leave early.

Quick start guide:

The 10 steps to employee ownership

- **Clearly list your key business outcomes.**
  What do you want to achieve from offering an ESS? Is it to attract new staff, retain existing key people, motivate your team for better performance, fund the retirement of founders, internal succession, management buy-out, or a combination of several of these?
- **Understand your business valuation.**
  What is the business worth and what are the key drivers? More importantly, how will you accelerate this value.
- **Financial modelling.**
  Understand the various levers used in designing the ESS to achieve the outcomes and check that the model works in terms of percentage of equity, number of employees and profit sharing.
- **Determine which plan meets your needs.**
  For example, do you qualify for a start-up plan, and is this the right one for you?
- **Document the plan.**
  This includes the key rules for eligibility, entry, funding, exit, sell-down and dividends etc.
- **Educate key employees.**
  Make sure everyone understands the plan and what's in it for them.
- **Update the valuation annually.**
  This is a taxation requirement, but more importantly it shows employees how the plan is progressing.
- **Provide information to employees.**
  Not just valuation but also basic company key performance indicators to help them deliver results.
- **Market the employee ownership aspect.**
  Employee ownership is popular for both recruitment as well as with customers.
- **Review and update the plan.**
  Regularly review the plan to make sure it still delivers on goals and outcomes.

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