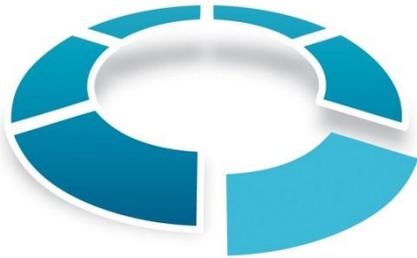




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## Employee Share Schemes – Their Importance to the Economy

**Employee Ownership Australia and New Zealand's (EOA)  
Expert Panel's Research Report**

July 2014





## Introduction

This report has been created to show the value of employee equity plans to the Australian economy and the positive revenue impact that can be made by reversing some of the changes in the 2009 legislation. NB: for transparency and certainty EOA's Experts panel advocate that the reporting regime remains and that \$180,000 limit of tax exempt plans remains. Many of the concerns related to Division 13A could have been resolved through the introduction of a reporting regime.

## Executive Summary - The Importance of Employee Ownership in Australia

Employee companies consistently out-perform their peers in a downturn. Some useful company case studies in this area are John Lewis Partnership (UK) a retail department store, Publix Supermarkets in the US, Arup (UK and Australia), all of which are considered to have best workplace practises and to have outperformed peers through the GFC. John Lewis Partnership has delivered employees after tax bonuses of 15% for the last 7 years (for every employee) whilst other similar sized listed entities in the UK have delivered between 0 – 3% in average bonuses over a similar period. Publix is the fastest growing supermarket chain in the US with almost 200,000 employees that has been voted in top 100 companies to work for, for 15 years.

In this report we examine the impact that reform in this area could have on the Australian economy, specifically if there is a reversal of the 2009 legislation and removal of tax at cessation as a taxation point.

Our findings are twofold:

- Employee ownership reform is likely to have a potential \$1.4 billion positive impact on the economy over a 10 year period;
- For both salary sacrifice plans and options plans the reversal of the 2009 changes will have a significant impact which would result in an increase in amount of ESS revenue subject to income tax which would be equivalent to \$215.6 million year on year once the changes have been implemented and reflected in company numbers.

Both of these figures suggest that this reform would be a good initiative to help boost the economy.

## THE POSSIBILITIES FOR THE AUSTRALIAN ECONOMY

The 2009 changes led to a decrease in broad based employee equity plans by 30% over the first three years that it was implemented<sup>1</sup>.

Assuming that 5% more companies offer employee ownership this has the potential to create an uplift of 10% year<sup>2</sup> on year for companies that implement broad based employee share plans. Effectively this would equate to a potential \$1.4 billion growth to GDP over 10 years. This number is calculated based on the SME companies involved having, on average, a market capitalisation of \$25 million<sup>3</sup>.

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<sup>1</sup> Employee Ownership Australia and New Zealand Report, April 2013 <http://www.employeeownership.com.au/wp-content/uploads/2012/01/EOA-Div-83A-Report-April-2013.pdf>

<sup>2</sup> Based on the average increase in value of the UK FieldFisherWaterhouse Employee Ownership Index, 1992 – October 2012.

<sup>3</sup> Based on ASX SME figures (in these figures most companies fall within the \$10 - \$50 million market capitalisation) see [http://www.asx.com.au/documents/media/110328ASX\\_SME\\_Equity\\_Market.pdf](http://www.asx.com.au/documents/media/110328ASX_SME_Equity_Market.pdf)



*Where there is a broad based employee share plan in a company there is proven evidence globally that this alone can improve company performance. Where there is a real depth of ownership, key information is shared with employees and they have some part in the decision making process then employee ownership has significant impacts on productivity.*

## The Importance of Start-Up Companies in Australia

Start-ups have a significant role in the Australian economy. They are critical to lift productivity, competition, economic growth, and employment through the creation of, and access to, new markets and the invigoration of established markets.

Innovation-active companies are also significantly more engaged in the digital economy, earning over \$144 billion in internet commerce in 2010-11 collectively, more than three times that of non-innovators. Innovation also encourages a more connected and skilled economy with greater market diversity and consumer choice.<sup>4</sup>

Start-ups could potentially contribute \$109 billion and 540,000 jobs to the Australian economy by 2033. There are 1,500 start-ups in Australia with the key hubs in Sydney and Melbourne<sup>5</sup>.

However, start-up and other SME companies with limited ability to pay the salaries necessary to attract and retain talent were the hardest hit by the 2009 ESS changes. These companies rely on equity to provide a share in future rewards rather than pay salaries, and their employees correspondingly invest their time rather than get paid for it. Start-ups were affected by the changes to the 2009 legislation particularly the change to the taxation point of options (the taxation point for options was changed from exercise to vesting). Start-ups also faced (and continue to face) other issues from the corporations regulation. The inability of start-ups to effectively access ESS will undoubtedly impact the projected contribution noted above. Any changes need to consider a holistic approach to what is needed to super charge our innovation sector.

## Options – The Impacts to Tax Revenue

The 2009 ESS changes, which resulted in most option plans becoming taxable at vest (rather than when Options are exercised) has meant that option plans dramatically declined post 2009 for many start-up or resources sector companies. Pre 2009 85% of start-up/growth sector companies used option plans post 2009 this number dropped to 6%.

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<sup>4</sup> Australian Innovation Systems Report 2012,  
<http://www.innovation.gov.au/Innovation/Policy/Pages/AustralianInnovationSystemReport.aspx>.

<sup>5</sup> Google recently commissioned a PwC report, “The start-up economy, How to support tech start-ups and accelerate Australian innovation”, in April 2013



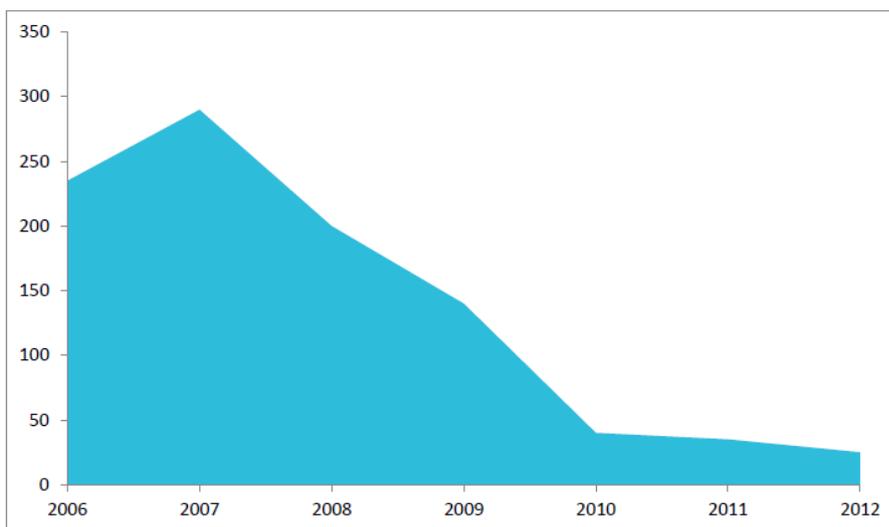
The EOA expert's panel wanted to undertake some modelling if the 2009 regime were reversed. Data was collated from Link Market Services Limited and Computershare's databases and following assumptions were used in the modelling:

- In 2009 the average number of employees in each option plan was 54.
- We have assumed that the option plans would increase if the 2009 changes are reversed, from the current level to a conservative number such as 100 plans. This number is less than the height of options plan usage (300 plans) and the pre-2009 changes (150 plans) but substantially above the current number.
- The increase in plans equates to 75 more plans.
- The average employee holding value pre 2009 was \$32,495<sup>6</sup>

Based on the above assumptions the potential increase in amount of money that would be subject to income tax per annum is \$131.6 million.

*Division 83A has significantly reduced participation in ESS option plans.*

Figure 5: Decline in Option Plan Usage after the 1 July 2009 changes



Note: Employer population based on 500 employers.

***If option plan taxing is returned to the pre 2009 position then there is a potential to increase plan usage by over 200% and increase income taxable revenue by over \$131 million.***

<sup>6</sup> This number is based on the average value of the options held by an employee during 2005-2009 financial years. It is calculated using the following calculation number of options x current share price then reduced by 30% (which is a basic rule of thumb Black Scholes Value).



## Salary Sacrifice the Potential Upside

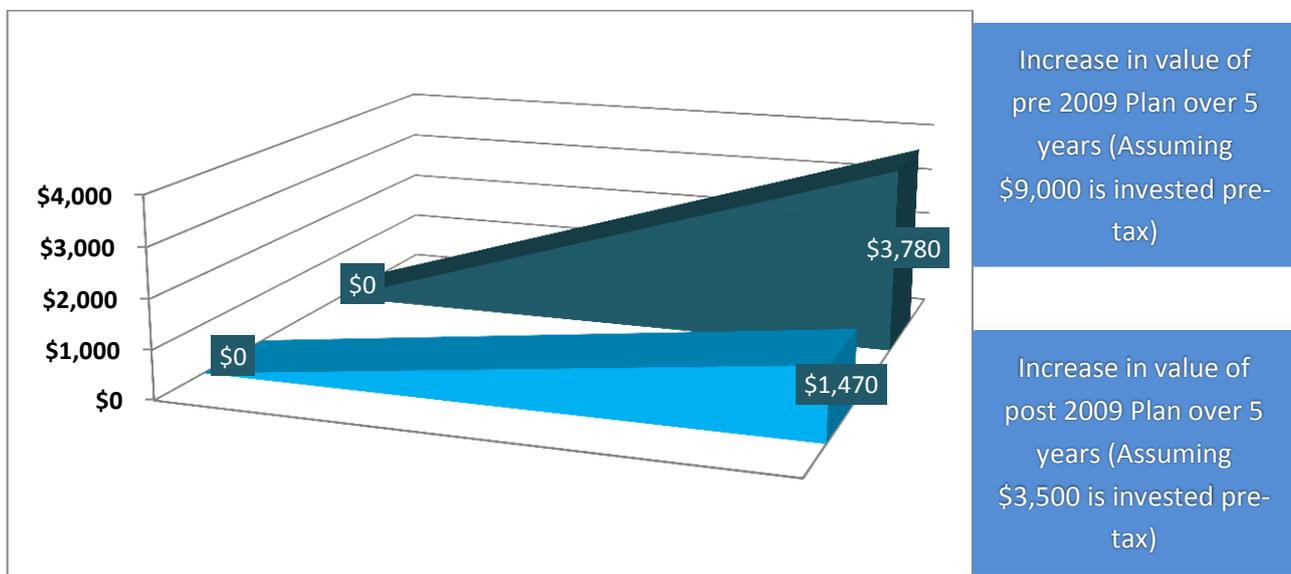
Salary sacrifice plans were also affected by the changes that were implemented in 2009. Salary sacrifice plans are most frequently used at the employee and middle management level to create a means for employees to accumulate company shares, save money for up to seven years (previously ten years) and for some employees this was used to supplement their income, help with discretionary purchases, help with education costs and add to retirement income.

The imposition of the Risk of Forfeiture requirement, as well as the creation of the genuine disposal restriction concept has made the salary sacrifice plans less attractive to employees. Previously there was a restriction condition that operated during the maximum ten year tax deferral period. Often an employee would be allowed to request a withdrawal prior to that period to access their shares. In practice 85% of employees did not access their shares prior to the end date. However, the previous legislation allowed greater flexibility and was perceived as more attractive to employees.

The current legislation requires the disposal restriction to apply from the date of the offer and can only be removed in extreme cases, such as financial hardship or special circumstances. This rule appears to have been administered very stringently by companies, in part due to the interpretation of the provision by the Australian Taxation Office. This change, has led to a decline in both the offer of, and the participation rates in this type of plan. In practice companies have tended to now use a restriction period of three years. The majority of participants in these plans now sell their ESS shares after the three year restriction period to enable them to fund their income tax liability, hence diminishing the returns they may have otherwise enjoyed from holding their salary sacrifice shares for up to 10 years.

*The imposition of a \$5,000 salary sacrifice cap has significantly reduced the average salary sacrifice levels of employees from \$9,000 to an average of \$3,500 per employee and many companies no longer use such plans. During the period of 2007 – 2013 savings under UK employee share plans grew by 116% so it is fair to assume the impacts in Australia were largely tax driven.*

The EOA expert's panel wanted to undertake some modelling if the 2009 regime were reversed. Data was collated from Computershare Limited and Link Market Services Limited's databases below is the projected increase in value of the holdings during 5 year period (this amount is the amount that would be subject to income tax):





Following assumptions were used in the above modelling:

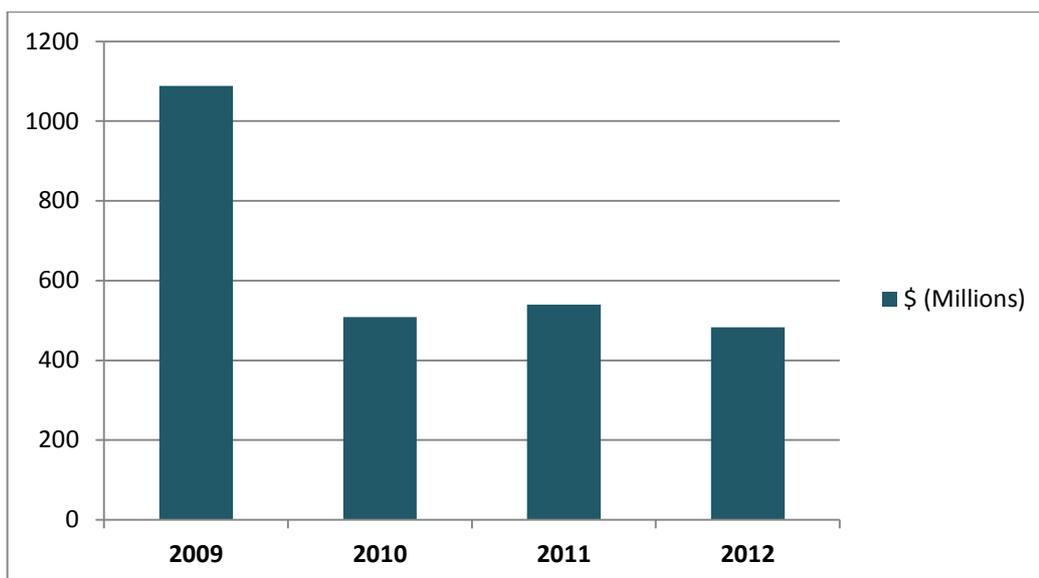
- The increase in value does not factor in the base amount which would be subject to income tax regardless of whether it was salary or in a share plan;
- The increase in value of the shares is based on 42%, which reflects the increase in the All Ordinaries Index since 2009 – 2014. The dollar value in the above table is the projected increase in value of a \$3,500 holding and \$9,000 holding over 5 years using that 42% increase;
- The modelling is based on one year’s contribution only, commonly employees will contribute year on year once they are part of the plan so this figure could be up to 4 – 5 times higher.
- The calculation does not factor in additional dividend income and tax revenue from this.

\*Note this does not factor in the potential savings impact or the impact on discretionary spending on the economy that would have naturally resulted from these plans. I.e. employees commonly use the money for retirement or to assist with major purchases like a house, education for a child or a family holiday.

*Assuming that salary sacrifice plans increase by 10% on the current employee numbers of approximately 400,000 and the average amount increases to \$5,000 then the potential increase in tax revenue would be \$84million. This number is based on the new employees only, a 42% increase in value and also assumes that current employees do not increase their current salary sacrifice level.*

In order to validate this data we also used the database to see what the actual amount of money that was subject to income tax only during the 2009 – 2012 reporting years (salary sacrifice plans only). The table below shows the actuals combined data in this area:

### ACTUAL REVENUE IMPACT OF 2009 CHANGES



### Cessation of Employment as a Taxing Point – Impacting Good Leavers

Cessation of employment was originally introduced as a taxation point prior to the reporting regime being introduced and was partly introduced in relation to concerns about employees leaving the jurisdiction post-employment and this creating potential collection issues.



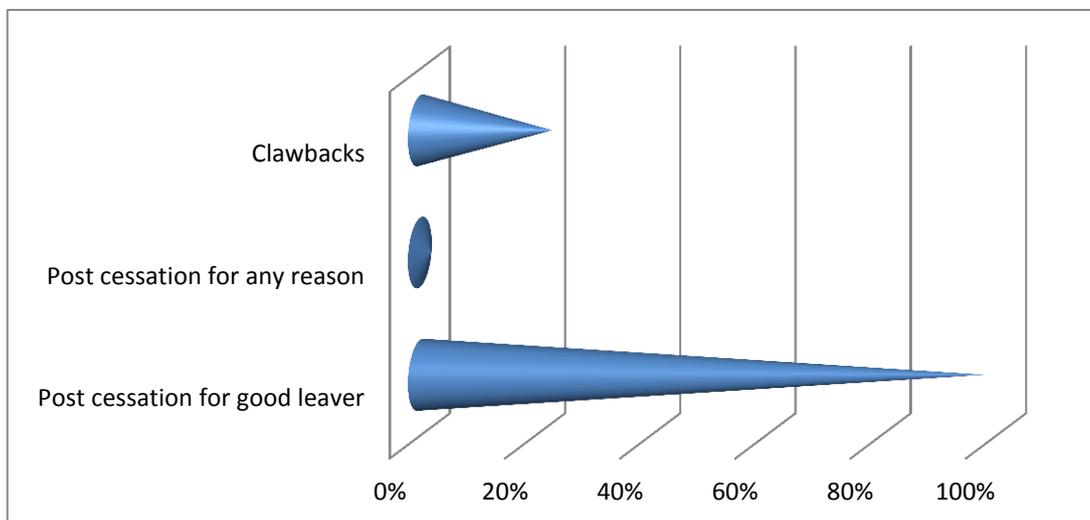
Cessation of employment is usually a trigger for employee plans to cease to be restricted and the employee to be taxed where they participate in salary sacrifice plans or tax exempt.

However, for all other types of plans cessation of employment no longer necessarily triggers vesting of awards. Changes in Corporations Laws and corporate governance standards have significantly changed share plan practices at cessation of employment. Generally if an employee is classified as a good leaver, i.e. if they leave due to death, total and permanent disability, retirement or redundancy, their equity would remain in the plan until the testing/vesting date and then vest based on the performance/time testing at that time. In other situations commonly they lose the equity and no tax is payable, i.e. if they resign or are dismissed with cause.

In the current financial climate there are a growing number of employees that are made redundant and are facing a tax liability on their equity. In most instances they may not have sufficient funds to meet the tax liability (if the share price has shifted) and rarely get the full equity grant later, i.e. when it is tested 1 – 3 years later<sup>7</sup>. This results in individuals in difficult situations facing large tax liabilities at a time when they can least afford to pay for the taxation. Many companies have changed their plans to indeterminate rights to avoid unfavourable conditions for their good leavers.

This provision also runs contrary to clawback requirements, good stakeholder governance and the Productivity Commission’s recommendations in this area.

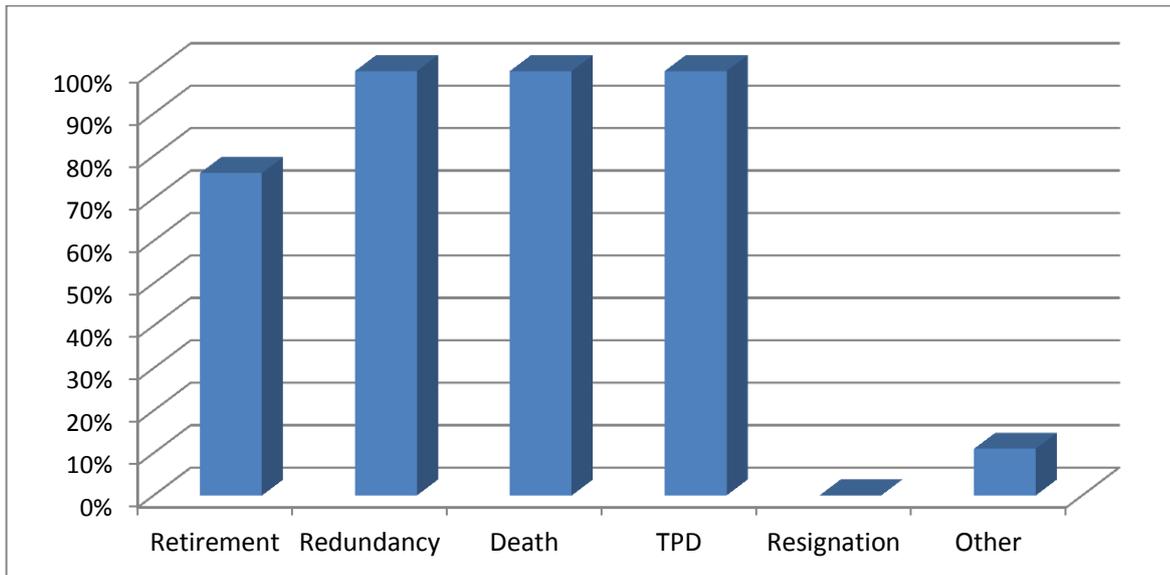
Below is a table that shows the percentage of plans that have good leaver as the only reason why performance conditions continue:



### DEFINITION OF A GOOD LEAVER

Below is a table that shows the percentage of plans that include certain conditions in the term good leaver:

<sup>7</sup> Approximately 90% of plans do not vest fully when they are tested.



The number of plans that have some vesting post cessation of employment has dropped from 43% - 12% in 2014 (most companies have moved to Indeterminate Rights or have allowed forfeiture pre termination of employment to avoid adverse consequences for their employees).

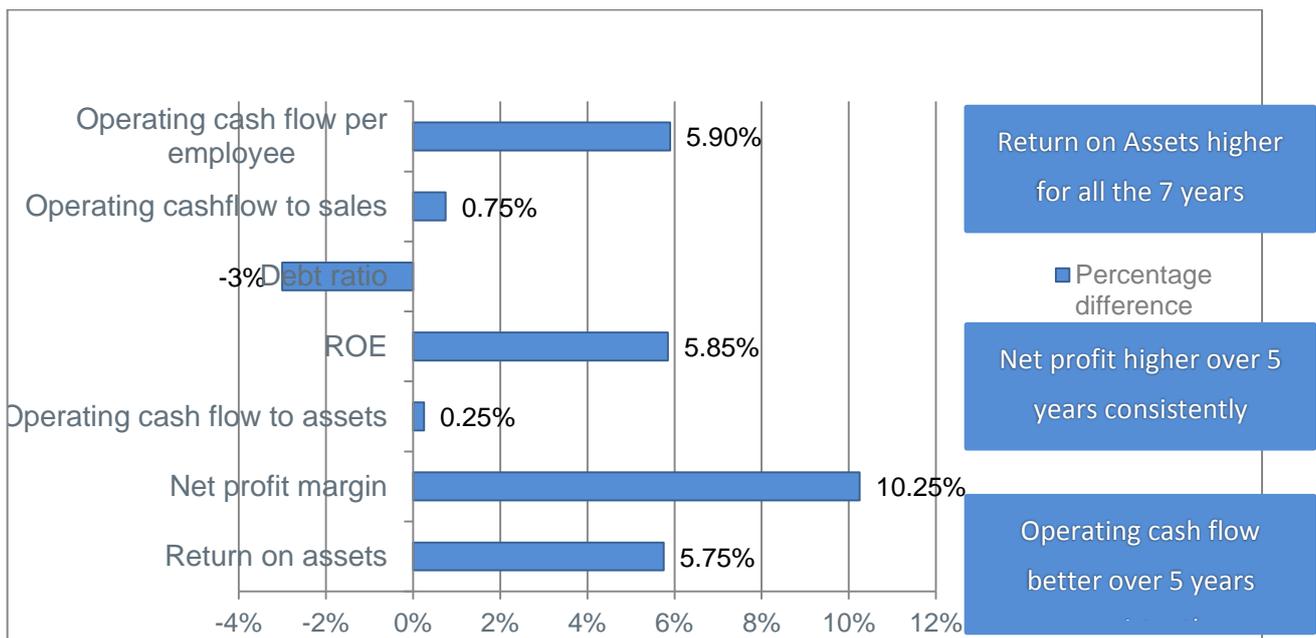


## The Link to Productivity

There has been a wealth of research about the link between employee ownership and productivity and/or company performance. We have set out below some of the findings in Australia, the UK and US. We have used the UK Employee Ownership Index (EOI) as a baseline to look at potential growth that could happen in Australia if broad based employee ownership increased by 20%.

### THE US PERSPECTIVE<sup>8</sup>

The table below is based the research in the article called the "The ESOP Performance Puzzle in Public Companies"<sup>9</sup> and looked at 196 publicly traded U.S. ESOP companies during the years 1998 through 2004. Each ESOP company was matched to a comparable non-ESOP company. This is one of the few public company studies to use the more methodologically rigorous matched-pair technique. The ESOP companies had returns on assets that were higher than the matched non-ESOP companies in all seven years, net profit margins that were higher in all of the five years where comparable data was available and better operating cash flows in three of the five years where data were available. The authors present the data for each year, rather than as a single summary measure. Below, we show the NCEO's (National Centre for Employee Ownership) calculated mean of the difference for the years in question.



<sup>8</sup> In "The ESOP Performance Puzzle in Public Companies," published in 2006 issue of the Journal of Employee Ownership Law and Finance, Robert Stretcher, Steve Henry, and Joseph Kavanaugh, 1998 - 2004

<sup>9</sup> Published in 2006 issue of the Journal of Employee Ownership Law and Finance, Robert Stretcher, Steve Henry, and Joseph Kavanaugh, 1998 - 2004



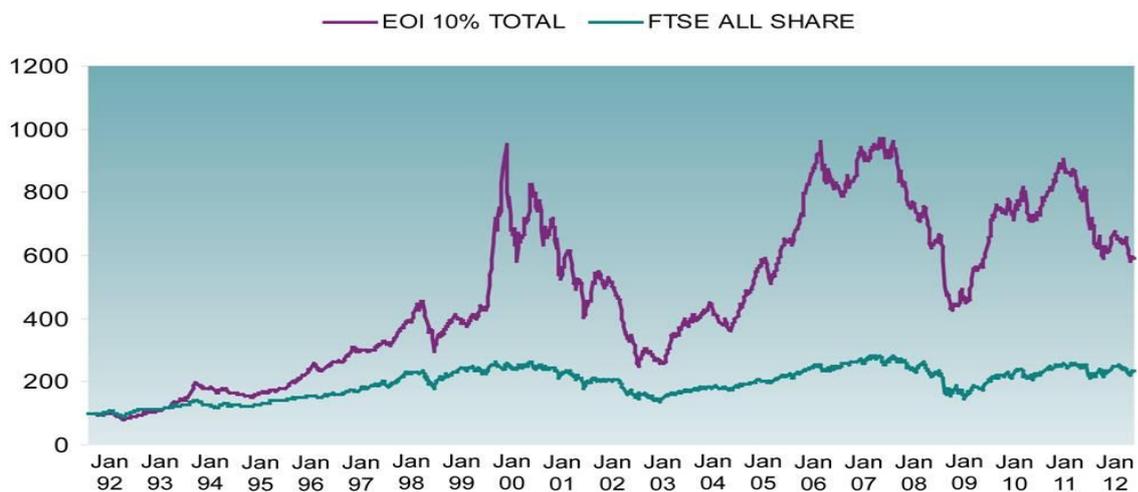
## THE UK PERSPECTIVE<sup>10</sup>

The Employee Ownership Index (EOI) is published by the Equity Incentives team at law firm, Field Fisher Waterhouse LLP. It monitors the share price performance of listed companies, comparing the performance of FTSE All-Share companies with companies that are over 10% owned by employees.

The EOI tracks performance of UK quoted companies that are over 10% owned by employees (excluding main board directors) or employee trusts.

An investment of £100 in the EOI when the index began in January 1992 would at the end of June 2012 have been worth £591 whilst the same investment in the FTSE All-Share Index would only be worth \$235.

**10% EOI versus FTSE All Share from Jan 1992 to Jun 2012**



In the UK 10% or more Employee Ownership creates an average outperformance of the market by 10% year

## THE AUSTRALIAN PERSPECTIVE<sup>11</sup>

There is limited research in Australia in relation to productivity and this study though useful has limitation. The limitations of these findings are that the data has been averaged across the eleven companies in the study.

The study was conducted over 5 years and showed that the companies that offered broad based employee ownership on average outperformed the index by more than 5%, had better share price growth, better P/E ratios and a higher dividend yield.

<sup>10</sup> Source FieldFisherWaterhouse Employee Ownership Index, 1992 – October 2012

<sup>11</sup> Source The benefits of promoting employee ownership incentives to improve employee satisfaction, company productivity and profitability. E. John McElvaney Deakin University 2011



The research also showed the implications of investing in \$1,000 employee tax free share allocation, as opposed to investing in the All Ordinaries Index or paying off a home loan with the same value. Even if the employees were not issued the shares free, but as part of a salary sacrifice program, the employees were 35.6% better off than if they invested that money across the All Ordinaries Index of the Australian Stock Exchange. If they had taken the \$1,000 as part of their annual salary and paid it off their standard home loan they would still be 15% worse off than taking employee shares.



## About EOA

Employee Ownership Australia and New Zealand (EOA) was formed in July 2011 to ensure ongoing advocacy for broad based employee ownership and dynamic workplace participation in Australian and New Zealand companies. It engages with and assists companies that have or aim to implement employee ownership or employee share plans, whilst also being a key advocacy body for broad based employee ownership. EOA is independent and entirely member funded.

EOA is a member-focused, not for profit association and replaced the Australian Employee Ownership Association which was formed by 20 companies in 1986. EOA is the only independent, dedicated advocacy and education group in this space in Australia and New Zealand.

## About the Experts Panel

Members of the EOA Experts Panel are selected by EOA based on their combined experience of consulting in the employee share plan space over several decades. To be invited to be a member of the Experts Panel the individuals must have over ten years' recognised experience in designing, managing and implementing employee ownership plans. In addition, the individuals selected by EOA are recognised by their peers as practitioners of excellence in this area. The Experts Panel members have been selected from the leading tax and legal professional firms and share plan administrators and registry providers in Australia.

The Experts Panel's philosophy regarding broad based employee share ownership is aligned with that of the EOA.

## EOA'S CORE OBJECTIVES

Since its incorporation in July 2011 the EOA's core objectives have been:

- to be the centre of excellence for companies seeking to implement or support employee ownership;
- to be the principal voice for the advocacy of employee ownership in Australia and New Zealand;
- to increase employee involvement, engagement and participation in workplaces through broad based employee ownership;
- to encourage research into the productivity impacts of employee ownership;
- to encourage Governments at all levels to develop taxation and other incentives to promote broad based employee ownership; and
- to provide exceptional services to our members.



### EOA'S POLICY RECOMMENDATIONS

The EOA recommends that public policy should be formulated so as to promote broad based employee share ownership based on the following key objectives:

- to better align the interests of employees and employers so as to promote employee engagement and productivity;
- to enhance national savings;
- to facilitate and encourage the development of small to medium, privately owned enterprises including start up companies; and
- to facilitate employee buyouts and business succession.

