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Employee share schemes: What are they, and could they work for your business?

Employee share schemes — or ESSs — 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 employee share scheme 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 employee share scheme?

Simply, businesses offer ESSs 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, ESSs aim to maximise the value of the business over the longer term by creating a team that is single-minded about working towards and sharing the benefits of a successful and profitable business.

ESSs are used for several reasons:

1. To offer employees a competitive remuneration 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 ESSs 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.

However, it's important to explore what your employees or job candidates actually want. You may discover that for many, income is not the predominant driving factor. Most of us are looking for a flexible and enjoyable work environment, professional development and a pathway to career progression, as well as 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 business' success and encouraged to stick around long-term.

2. 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% have been recorded at companies that get this mix right.

3. To encourage staff to stay in the business long-term

ESSs can be structured to match and deliver business goals and outcomes, the most common being employee retention. By implementing rules within your ESS — such as clauses if the employee leaves the business early, or ongoing contributions if the employee stays in the business — more employees can be motivated to stay.

4. For succession planning

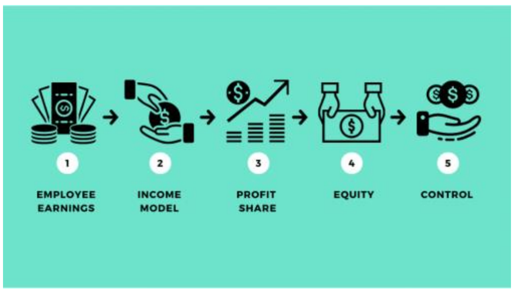
An ESS can be an effective employee buy-out instrument when founders want to exit the business. By providing a combination of financial harvest or selling the equity to remaining staff at a reasonable price, and stewardship, or enabling trusted key people to continue the culture, style and character 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.

5. For funding retirement

ESSs 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 the business to an external buyer.

The employee share scheme ladder to equity

A word of warning: jumping straight into offering equity is almost always the wrong way to go about it though. 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:



The ladder to equity

1. 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 doesn't include performance rewards. The next step is to consider other dollar-based

2. 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 too 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.

3. 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 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.

4. 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 behaviour and goals with the business and owners.

Later in this guide are the different types of ESSs that businesses can consider.

5. Control

Often this step is never utilised though on occasion 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 employee share scheme process of becoming owners, a way to gradually bring them around to thinking and acting like one.

Note however that the 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'

Startup plans

Introduced by the Government as part of its Industry Innovation and Competitiveness Agenda, startup 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; and
- Participants are generally only taxed on disposal of shares or options and with a 50% capital gains tax (CGT) discount.

However, startup 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 10 years old;
- Australian resident taxpayer; and
- Shares must be offered to 75% of employees with more than three years' service.

In addition, employees must meet the following criteria:

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

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); then
- The employee is taxed on capital, not income, and therefore typically at a lower rate — CGT at marginal tax rates.

Phantom share plans

While not technically an employee share scheme, 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.

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% of the issued capital or 10% of the voting rights.

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 disposal of the share.

For all ESS interests, the maximum deferral period under s83A-120(6) is 15 years after acquisition of the ESS interest.

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; and
- Is appropriate for both the long and short term.

Time to get started

Like the sound of these different types of employee share schemes, and think they would benefit your business? Then it's time to get started.