

EMPLOYEE SHARE OWNERSHIP

Encouraging employees to think and act like owners is the holy grail for all businesses. If this appeals, then read on.

There are 3 distinct roles in every organisation: Technician, Manager and Entrepreneur. Your reward system can provide the opportunity for employees to take on all roles.

First set out the short and long term needs and objectives for yourself, your organisation and its employees. This article addresses only the financial components in meeting those needs. Other needs, such as social and personal growth, are met in other ways.

COMPENSATION STRUCTURE

Consider a three-level compensation structure that complements these needs:

Base salary - the going rate for a person with the skills and experiences

Short term Incentives - team and individual performance bonuses

- Encourages focus on the achievement of business goals
- Allows employees to share in profits
- Rewards for meeting targets – eg quarterly payments

Long-term Incentives - employee share ownership plans

This article focuses on long term incentives.

Four types of long-term incentives are considered:

- Real shares
- Real share options
- Phantom shares
- Phantom share options

The choice will depend on the structure of the business, future plans for the business and its owners, and the intended outcomes of the plan.

BENEFITS

For employers:

- Promotes increased productivity.
- Encourages a strong personal interest in raising the corporation's profits.
- Gives employees a reason to contribute to the growth of your business.
- Encourages initiative.
- Fosters an ownership culture.
- Provides incentive to attract high calibre employees - improves the ability to recruit the kinds of people that help the business prosper.
- Promotes employee retention – gives them another reason to stay.

For employees:

- Provides an opportunity for employees to share in the growth of the company.
- Reward for contribution toward growing the business.
- Gives employees more rights and responsibility, as well as risks and rewards.
- Encourages greater commitment, provided they understand how their work affects share values.
- Provides an opportunity for employees to accumulate wealth.
- May provide the chance to participate in a public offering or sale of the company.

Depending on how the plan is structured:

- Needn't force the owner to give up control.
- Can be subject to vesting requirements.
- Can be forfeited upon an employee's termination or departure.
- Can be repurchased using payment schedules.

REAL SHARES

Shares can be either granted or sold to employees.

Benefits

- Simple implementation.
- Employer doesn't have to pay out cash if employees sell the shares; others may buy them if there is a market for them.
- A way to sell down ownership to employees.

Disadvantages

- On-going administrative costs of real share plans may be prohibitive. For a private company with 20 employees, setting up a share ownership plan could cost \$30-40,000 in advice and \$5-10,000pa to run.
- ASIC requirements.
- Generally no tax benefits, unless qualifying criteria are met.
- Dilutes ownership and share value.
- Small, closely held companies that don't want to go public or be sold may find it difficult to create a market for the shares.
- Real shares may need to be repurchased under the terms of a buy/sell agreement when an employee departs or is terminated.

Selling your Business through an Employee Share Ownership Plan (ESOP)

One way to sell your business to your employees is through an ESOP. 12% of all business sales in the USA are now made to "all employee" entities. This includes MBO's.

ESOPs are tax-qualified employee benefit plans that invest primarily in shares of the employer.

An ESOP may suit business owners who want to move gradually into retirement, providing a transition plan.

Tax

Care is required regarding *Fringe Benefits Tax (FBT)*, *Capital Gains Tax (CGT)* and *Payroll tax*.

There are tax concessions designed to encourage the establishment of ESOPs in Australia. These may be available to an individual selling the business to an ESOP and the employees participating in the plan. Qualifying plans provide shares or rights tax free to participants. No tax is payable on receipt.

The tax incentives and benefits of employees having ownership in the business make such plans attractive even when business owners wish to sell only part of their businesses.

SHARE OPTIONS

Share options grant employees the right to buy company shares at a specified price during a specified period. The price at which the options are provided usually reflects the value of the company at the time the options are granted. Employees hope that the value will go up. If the shares are openly traded, they will be able to "cash in" by exercising (purchasing) the options at the lower price and then sell the shares at the current market price.

Share options provide as a benefit only the **increase** in value of the shares rather than the inherent value of the shares. This distinction is important, as the reward is greater the stronger the company's growth.

Employees typically do not own the shares outright when options are granted. Share options vest (or become theirs to exercise) over a period of time, usually a number of years they stay with the company.

Benefits

- Reward employees based on the increase in value of the company.
- For growth-oriented smaller companies, options are a great way to preserve cash while giving employees a piece of future growth.
- Granting options incurs no charge to earnings.

Disadvantages

- Option plans that allow employees to sell their shares a short period after granting do not create long-term ownership vision and attitudes.

PHANTOM EQUITY

Large companies have the advantage of offering employees share options, but these may not be practical for start-ups and smaller businesses. Not every company owner wants to open up the share register to others.

Instead of giving employees real shares, a phantom equity program gives employees something that looks and feels like shares but is not shares. Phantom shares and phantom share options mimic the company's real shares and options but offer no rights to actual shares.

There are a number of situations that might call for a phantom share plan:

- The owners want to share the economic value of equity, but not equity itself.
- The owners have considered real equity plans but found the rules too restrictive or implementation costs too high.
- The company is a division of another company, can create a measurement of its equity value and wants employees to have a share in that value.

Phantom equity is an agreement between the owner and the employee which rewards the employee based on growth of the company. It is simply a promise to pay a bonus in the form of the equivalent of either the value of company shares or the increase in that value over a period of time.

Most phantom share agreements provide for paying bonuses to employees as though they owned shares. The bonus may be paid in cash, real shares, share options, promissory notes or other consideration.

Hypothetical shares are allocated by book entry to an employee's account. As the value of the company grows, so does the value of the phantom shares. If the employee remains with the company until the end of the restriction period, then the phantom shares are converted into actual shares or cash, or both. The employee is entitled to receive the difference between the market share value and the phantom share value. This payment is sometimes received in instalments.

The owner effectively 'buys back' the phantom shares with cash or pays out the increase in the value of the shares; or can convert to real shares.

A written agreement and a corporate resolution are drawn up. The arrangement is valid if:

- the corporation receives some type of adequate consideration for the payments to the plan participants
- there is a reasonable relationship between the value of the services rendered by the participant and the benefits granted to the participant under the compensation plan.

Rights of the employees, particularly as to their ability to redeem phantom shares, must be carefully structured to ensure the correct tax treatment and the desired deferred compensation incentives to attract and retain employees.

Benefits

- Flexible - can be tailored to precise business objectives as there are no regulatory requirements to be met.
- The benefits can be directly related to the achievement of designated criteria.
- Phantom share options can be converted to real shares without causing as much dilution, as there are fewer shares than would be needed with real share options.
- Can be tied to how long employees stay with the company and how well the business performs.
- Gives employees the economic benefits of owning shares without any actual transfer of shares.
- Allows employees to participate in the financial rewards of ownership without having a voting interest and without the complications associated with having additional shareholders in the company.

- There is no dilution of the ownership rights of existing shareholders as no share is transferred on exercise of the option.
- Phantom shares can disappear, based on certain triggering events.
- Phantom shares can also be valued using any formula that an owner and his advisors deem appropriate.
- Employer is free to pick as few or as many participants as needed, with complete flexibility for each participant's plan design.
- No cash outlay to purchase phantom shares.
- Administration cost of the plan is minimal.
- Tax advantages are attractive to both business owners and employees. When the employee receives phantom shares, the receipt is not taxable income to the employee until he or she actually receives the money or other benefit. The company is entitled to a tax deduction for the full cost of payments under the plan.

Disadvantages

- These programs are usually unfunded, with the benefits dependent on the solvency of the company at the time the funds are to be paid.
- If paid out as cash bonuses, this can impose a cash drain on the company. Issue too many share options, and you may have to pay out an enormous amount of cash.
- Superannuation guarantee contributions are payable.

PHANTOM SHARES VS PHANTOM SHARE OPTIONS

- With phantom shares the employee receives the underlying value of the shares, as well as any appreciated value. Whereas, with options, the employee receives only the appreciation in the share value.
- Phantom shares are a benefit in themselves, whereas options only reward employees for increases in company value.

PHANTOM SHARE OPTIONS

The phantom share option plan works in the same way as a company share option plan, where the bonus is determined by reference to the increase in value of the shares subject to the option. The difference is that no shares are actually issued or transferred on the exercise of the phantom share option. The benefits, however, can be just as real.

Benefits

- Rewards are based only on the increase in the value per share between the date of the award and the date of distribution.
- There is no exercise cost to the employee, as there would be with a real share option.
- With options, the employees only participate in the additional value that they help to deliver and do not participate in the value that already existed.

DESIGN CONSIDERATIONS

The success of the employee share ownership plan depends on the employer choosing the correct plan to achieve the desired goals.

Documentation

Prepare a shareholder's agreement - a written plan document specifying the following:

Class of shares and their rights

- Special classes of shares exclusively issued and held by employees. Eg non-voting common or preferred shares.

Quantity

- Work out the number of shares or share options to make available.
- Avoid giving out too much to early participants and not leaving enough for later employees. Consider how many staff you'll have, so that the right number of shares is granted each year. A common error is to grant too many options too soon, leaving no room for additional options to future employees.
- Each employee who participates in the plan is granted a certain number of shares or options.
- Place a limit on the total number of units that may be outstanding at any one time and the number that may be awarded to any one employee.

Decide who can receive and when

- Which employees are eligible to receive the shares or options eg all or only key employees.
- The basis of making available eg time, % of salary or perceived value to the organisation.
- When employees qualify to receive them, eg after 6 or 12 months
- Rate at which employees can receive options over the course of their career.
- For each year employed, opportunity to earn additional options, which will also vest over time.

Valuation

Determining what your company is worth is essential when setting up the share plan and making other financial arrangements. Owners often think they know their company's value, but they may be shockingly misinformed. Most misjudge the value of their businesses by 50% or more - sometimes by millions of dollars. So be sure your business is properly appraised before implementing any financial plan.

- A Good Valuation is essential.
- Decide how the shares will be valued and who will determine the value.
- Define a formula or methodology for valuing the shares.
- Provide for an objective valuation method which is perceived as fair by the participants.
- Avoid static valuation formulas as these may negatively influence employees' behaviour.
- Consider professional valuations or a group of indices, such as earnings per share, return on assets, return on equity.
- Valuation of phantom shares can be based on a simple standard such as the current book value of actual company shares.
- As the value of the company rises, so does the value of the phantom shares.

Vesting Schedule

- Help retain key individuals through the use of vesting schedules which give employees ownership of their shares gradually over a specified time period.
- The employee only obtains the benefits by remaining with the company for a certain number of years.
- Establish a universal vesting schedule or tailor to individual circumstances.
- The vesting schedule may be designed with specific objectives in mind.
- You can negotiate vesting individually to take into account the person's age and how much value you expect him or her the employee to bring to the company over the short and long term.
- Vesting periods of 5 and 10 years have been used ie 20% and 10% pa.
- Each year for 10 years the employee earns shares equal to a % share of the company's assessed value.
- If the objective is a combination of retention and performance, the vesting provisions can be tied to the achievement of certain financial targets.

Conversion of Options to Shares

- After the shares are fully vested, convert the options to shares by buying them for the option price.
- Decide when the options can be exercised.

Financing Conversion

- If you hope your employees will buy the shares and keep them, you may also want to provide assistance in financing the exercise price through employee loan programs. Eg low or interest-free loan.

Holding Period

- Require a minimum holding period. If the employee leaves before the holding period expires, the employee forfeits the shares.
- If the employer's sole objective is retention, the forfeiture provisions may be based solely on the passage of time (e.g. a five-year cliff vesting schedule, meaning the award does not vest at all until the end of the fifth year, at which time it becomes 100% vested).

Payouts

- Design the rules and timing for the withdrawal of earnings under the plan.
- You can also establish a payout period, after which time you will redeem the phantom shares for cash. In other words, your people do not have to leave the company in order to cash in their shares. You have some flexibility in determining the timing of the payment of phantom shares.
- At the end of that time, the employee may cash out over a 10-year period, collecting not more than 10% of the accumulated value each year.
- Define the terms and conditions under which shares can be sold eg only back to the company or on the open market if available.

Transfer Restrictions

- Eg cannot be exercised by anyone other than the option holder.
- Cannot be transferred by the option holder other than by will or by the laws of descent.

Employee Beneficiaries

- Designation of beneficiary and a contingent beneficiary for each employee.

Restrictive Covenants

- Employees may be required to agree not to compete with the company, not to become a competitor's employee after retirement or solicit employees or customers for a number of years following termination of employment.
- Employees may be required to agree to remain employed by the company for a certain number of years or until retirement.
- An employee must carefully weigh the benefits of participating in the plan and the associated decreased career mobility.

Escrow

- The company may use a restriction period to prevent any employee who leaves within a set number of years from receiving shares or cash.

Change of ownership

- Provisions to make the contract binding, even if someone else purchases the company.

Accounting

- Each unit reflects a percentage of the total value of the company.
- The employer establishes a "share account" for each participant.
- The employee is credited with "shares."
- A bookkeeping entry is made to that account each time shares are granted to the participant.
- Each year the employee becomes vested in shares in accordance with the written agreement.

Funding

- The plan can be informally funded to offset all costs on an annual, after-tax basis and to recover all costs over the working lives of the participants.

For a Phantom Share Option Agreement

- Set the minimum exercise price for the shares.
- Set the period during which the options may be exercised.
- Define specific periods for exercising the options under the plan.
- The company must decide whether it should grant options with an open-ended commitment as to the amount of bonus which may become payable when the options are exercised. It is fairly common to place a cap on the amount of bonus which is payable. There are several ways to cap the payment.
- The company can also establish a policy in connection with the grant of options. Exercising of options can be subject to performance targets.

Tax

There is no difference from any other salary or cash bonus plan. The employee does not recognise income when the phantom shares are granted, but must recognise ordinary income upon receipt of the cash bonus. The employee is taxed at ordinary income tax rates, and the employer receives a tax deduction at the same time.

The employee can effectively defer payment of taxes on this benefit until a liquidity event or retirement occurs. The time value of deferring these taxes can be significant.

When the company pays an employee to redeem phantom shares, the company can treat it as an expense rather than a repurchase of shares and the company receives a tax deduction.

When the right to the benefit is exercised, the value of the award is taxed as ordinary income and is deductible to the employer. If the award is settled in shares, the amount of the gain is taxable at exercise, even if the shares are not sold. Any subsequent gain on the shares is taxable as capital gain.

Where to go from here?

We recommend you educate yourself further and, if you want to set up a plan, hire the right people to help you. Supertrac does **not** provide this advice. This article is a spin-off from research for our own organisation. You should consult with your professional adviser to discuss your specific situation.

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