Employee Share Schemes

RESPONSE TO SHARE SCHEME CONSULTATION – April 2019

Prof. Andrew Pendleton

UNSW

Introduction

This response to the ESS 2019 Consultation is based on the UK experience of employee share schemes. The UK has a strong, long-standing, and clear framework for share schemes, with the core details of schemes well understood. Use of all-employee plans is widespread in the listed sector, especially amongst larger companies (FTSE 100, 350), and since the introduction of new plans in 2000 (Share Incentive Plans (SIP) and Enterprise Management Incentives (EMI)) increasingly used in the non-listed sector. The EMI option plan – aimed at small companies - has been particularly successful in terms of take-up: just under 10,000 companies were operating EMI in 2016-17. Details of the tax-advantageous schemes in the UK can be found at

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/732131/ESS_National_Statistics_Commentary.pdf

The author is an academic with lengthy experience of conducting research into employee share plans (see biographical note). He is particularly interested in the effects of share plans and in employee attitudes and behaviour in response to ESS. He was also a member of the UK Government committee that designed the Share Incentive Plan and Enterprise Management Incentives. He recently moved to Australia to become Head of the School of Management in UNSW Business School, Sydney.

Consolidating and simplifying existing exemptions and ASIC relief

(1.1, 1.2) There is a strong case for simplifying and consolidating the existing statutory and class order reliefs. Past experience from the UK, especially in relation to small companies, suggests that fragmentation of the regulatory regime and reliefs is a substantial barrier to take-up of employee share schemes and employee ownership. Small companies lack the resources to 'piece together' the various elements of the regulatory system, whilst many professional advisors outside the share plan 'community' are unwilling to do so on the grounds that complexity is unwelcome amongst their clients.

A strength of the current UK regulatory environment for ESS is that legislation has created several distinct ESS 'brand types', each with a set of clearly identifiable features including the scope of plans, nature of securities on offer, tax arrangements, etc. This provides an 'off-the-shelf' set of arrangements to be used by companies, and eases regulatory compliance by them. Approval in advance by the tax authorities ensures that schemes are compliant with the key regulatory requirements (though note that EMI schemes are exempt from prior approval). The 'brand' identity of the various ESS types facilitates implementation of them by those companies new to ESS.

An argument against ESS 'brands' is that discretion to vary ESS features to suit individual company circumstances is limited. This apparent lack of flexibility has been dealt with in more recent share schemes by providing more discretion within statutory frameworks: the Share Incentive Plan has four main different ways of awarding shares to employees, with companies free to choose which they use.

The different UK share plan types tend to work for different types of company: the SAYE all-employee option plan tends to be used by listed companies, whilst the SIP contributions and free shares plan is targeted at unlisted companies. The EMI options plan is targeted at unlisted, small, high-growth potential companies: it is a discretionary scheme that can be restricted to 'key employees' though some companies use it as an all-employee scheme.

(1.7) It seems undesirable to give ASIC an additional power to determine whether a company should benefit from an exemption to operate an ESS as this may provide additional regulatory uncertainty. It would be preferable to define in legislation which companies are able (unable) to offer share plans so that adjudication is more clearly limited to cases at the margin. In the UK the primary requirement is that a company offering an ESS should not be under the control of another – whilst this can give rise to complications in the case of multinationals based elsewhere, it provides valuable protection to employees. The EMI scheme has additional requirements to ensure that 'primary' companies (rather than entities established to licence products made by others, for instance) benefit from the generous tax concessions.

Increasing the offer cap per employee

(2.1, 2.2). The current cap of $5000 per employee per year is low by international standards, and it seems likely that an increase to $10,000 with an associated fall in the proportion of scheme costs will make schemes more attractive to some companies.

Should $10,000 be adopted it might be beneficial to have an approximate yardstick to guide regular up-ratings. Since the $10000 limit is approximately equal to one-eighth of average earnings, this might be used as a peg for future increases in ESS limits.

However, there are dangers of increasing the limit to $10,000 in relation specifically to contribution-based schemes:

- Low income employees may be tempted to subscribe too large a proportion of their income to the scheme, leading to problems in other areas of consumption. In practice, our UK research shows that this is not a widespread problem.

- When limits are raised, some employees may substitute additional ESS saving for other forms of saving so that their medium-term wealth becomes unduly reliant on company shares and the risks that this entails. It is undoubtedly the case that some employees have employer shares that constitute over 50 per cent of the value of their medium-term wealth (ie not including superannuation) but it is not clear that raising contribution limits *per se* significantly impacts on this. We have the data from the UK to explore this more deeply, and will be happy to discuss doing so if this would be useful.
- Previous research in UK and Australia shows that higher income employees are more likely to contribute, and to contribute more, to contributory schemes, and hence are likely to benefit disproportionately from tax concessions available to ESS. This may raise issues of fairness.

In the light of the above, there is a case for increasing the cap on total annual ESS allocations to $10,000 in unlisted companies but that employees should have some protection against risk. This might take the form of a lower cap on contribution-based components of share awards (say $5,000) but there is the danger that a split cap will add to complexity.

(2.4). It is difficult to make a general case that senior managers should be excluded from a cap that applies to others. In reality, our research shows that senior managers will contribute more than other employees within the framework of a cap so there is some adaptation according to circumstances.

But, there is a case for senior executives having the potential to receive large option awards (in excess of $10,000) in high-risk-growth companies as a counter-balance to the reward packages available in large corporates. This requirement is probably dealt with better by having a specific scheme for these circumstances (similar to the UK EMI, for instance) rather than allowing senior managers to sidestep the limits of all-employee schemes. A key element of all-employee schemes is their integrative character: enabling some senior employees to sidestep their requirements may detract from this.

Facilitating the use of contribution plans

(3.1) There are good grounds for extending contribution plans to unlisted companies. Owners/managers of smaller, privately-owned companies are typically more wary of offering 'something for nothing' than managers in larger, listed entities, and hence contributory plans, where employees demonstrate their commitment, are often likely to be more appealing than free awards. Employee subscriptions also provide a source of 'friendly' capital that can be highly beneficial for small, unlisted companies.

But this also poses dangers that some companies abuse employee contributions, and for this reason a cap on contributions may be desirable.

Regular valuations are also highly desirable in these circumstances. UK experience suggests that this need not be especially onerous for unlisted companies. In the UK, unlisted companies participating in the Share Incentive Plan are required to agree a share valuation with the tax authority (HMRC) for the share transaction (and for subsequent transactions such as share buy-backs from employees who leave before tax exemption holding periods have expired). These valuations last for a defined period of time, not more than six months. Similar procedures apply for the valuation of shares

where options are issued or exercised under the Enterprise Management Incentives plan. Companies are required to submit a valuation, along with supporting documentation, which may be calculated using a third party.

In these arrangements, companies propose the value of the shares, using well-established valuation methods, with the tax authority then checking compliance with these principles. There is clearly a compliance cost here, and it is vital that the tax authority has adequate resources to undertake compliance checks in a timely manner. Although opinions differ, it is probably fair to say that the dominant view from UK corporates and share scheme practitioners is that this process can sometimes be an 'irritant' but that it does not act as a major impediment to the use of ESS.

Several share scheme practitioner and lobby groups have banded together to assist the tax authority in providing worked examples to assist in share valuations. See

https://www.fieldfisher.com/media/2017/10/employee-shares-worked-examples-group

Other reforms

There are a variety of reasons for small businesses wanting to share ownership with their employees. ESS may assist small firms in recruitment and retention of staff (UK research indicates the latter is more a more widespread objective than to aid recruitment amongst small firms), and the reforms included in this consultation should assist small firms in offering ESS for these reasons.

However, these reforms are unlikely to assist firms that seek to transfer ownership to employees for business succession reasons. Indeed, small scale transfers of ownership to employees may impede business succession as third party acquirers may not value employee share ownership in a positive light.

Some owners wishing to exit prefer to sell their companies to their employees rather than to a third party via a trade sale. A different instrument to facilitate this is required. Since 2014 the UK has legislation which provides capital gains tax and inheritance tax exemptions to business owners who sell 51 per cent or more of their business to a qualifying Employee Ownership Trust (a special purpose employee benefits trust). EOTs are a fast growing form of employee ownership. See, for further information:

https://employeeownership.co.uk/wp-content/uploads/DAY-1-14.45-15.45-EO-Sector-Update.pdf

Biographical note

Andrew Pendleton is Professor and Head of the School of Management in the Business School, UNSW. Biographical information can be found at https://www.business.unsw.edu.au/our-people/andrew-pendleton#PublicationsResearch

He is an expert both on employee share schemes and on employee ownership (i.e. where employees own all or most of their companies).

He was a member of the UK Inland Revenue Advisory Group that designed the Share Incentive Plan and Enterprise Management Incentives (introduced in the Finance Act 2000).

He is currently carrying out research into employee participation in employee share schemes in Australia in collaboration with a major share plan administrator, and is also conducting similar research in the UK.