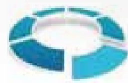


How to Create a Vibrant Ownership & Productivity Culture

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

June 2017

Executive Summary

This report is based on the responses of 68 companies across all sectors and there were some really clear themes that emerged from the responses:

Tax at cessation of employment is the biggest barrier to long term employee ownership and in a changing and increasingly mobile work force its effects will only continue to increase. This should be the first focus for any change in this area.

Removing tax at cessation for all leavers will encourage long term owners and savers.

The jury is still out on whether withholding tax is the answer but at the very least it should be available for companies that want to implement it (similar to the New Zealand model).

The tax exempt plan and the current $1,000 is too low and an increase in this could be implemented with no or low revenue cost to Government if it is applied only to free shares. This plan is focused on lower income employees so this should be considered a positive outcome.

The salary sacrifice plan if increased could add a significant impact on employee savings and retirement wealth above the current $5,000. To ensure that it helps the right bracket of employees there could also be an income cap applied to any value above $5,000 (similar to the cap in the tax exempt plan so that it is simple for companies to administer).

The Importance of Employee Ownership in Australia

Recent research by EOA has shown the importance of broad based employee ownership for company performance. The most recent EOA Index results showed that companies that have broad based employee ownership outperform their peers by 17%.

http://www.employeeownership.com.au/employee-ownership-index/

Employee Ownership has a particular importance for investors because of the linkage between broad based employee ownership and environmental, social and governance (ESG) standards. CAER helped EOA undertake research on ESG factors. Ms Julia Leske, who is the CEO of CAER has stated that "CAER's research shows companies with employee ownership schemes also have better environmental, social, governance and ethical standards. This is particularly important to fund managers that incorporate ESG into their investment considerations. Responsible investors should be looking for companies with high levels of employee ownership because their ethical performance is better, as is their share price."

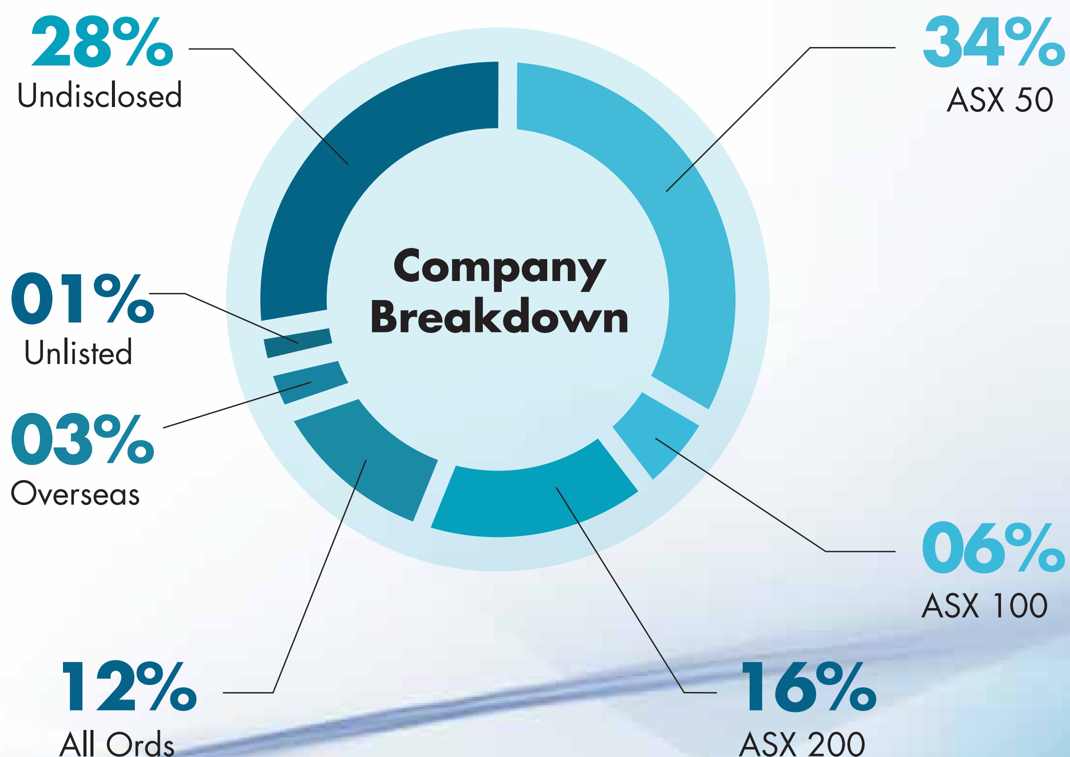
Introduction

Employee Ownership Australia (EOA) is an independent voice of employee ownership and a centre of excellence in Australia. We have been responsible for helping drive key changes in both Corporations Law and taxation of Employee Share Schemes (ESS) over the past 5 years. Given the recent changes that have taken place we were keen to understand if there are any remaining barriers for the listed companies to advocate for.

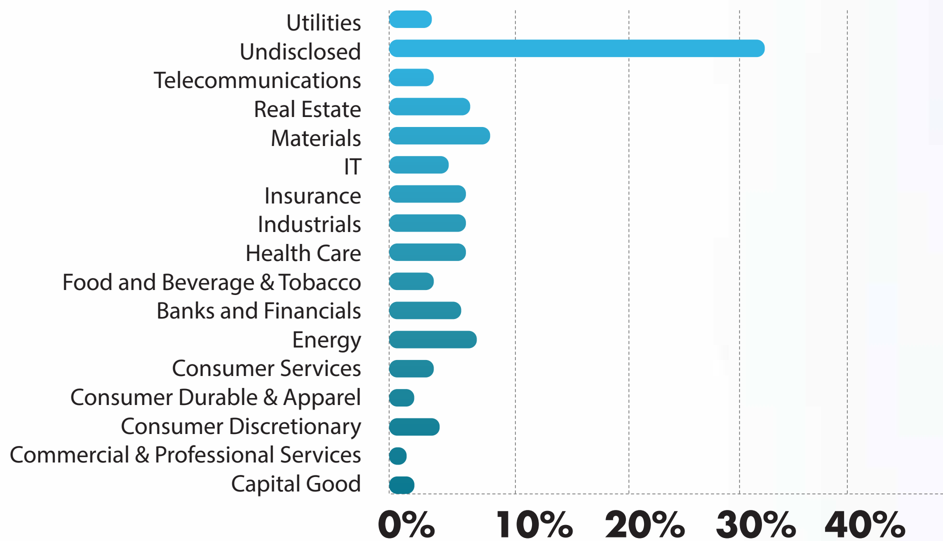
Surveys were sent via our expert panel and EOA networks to companies that had been identified as having some form of employee ownership in place and also to key ESS policy decision makers. It was important to get a good cross section of responses across different companies and industries.

EOA has previously been in dialogue with companies through its Inner Circle group, at various roundtables as well as at it's conferences and the questions were created from those discussions. The questions are set out in detail below along with the summary of the replies.

In total 68 companies participated in the survey and below is the breakdown by size and sector:



Sector Breakdown



The Key Barriers to an Ownership Culture in Australia

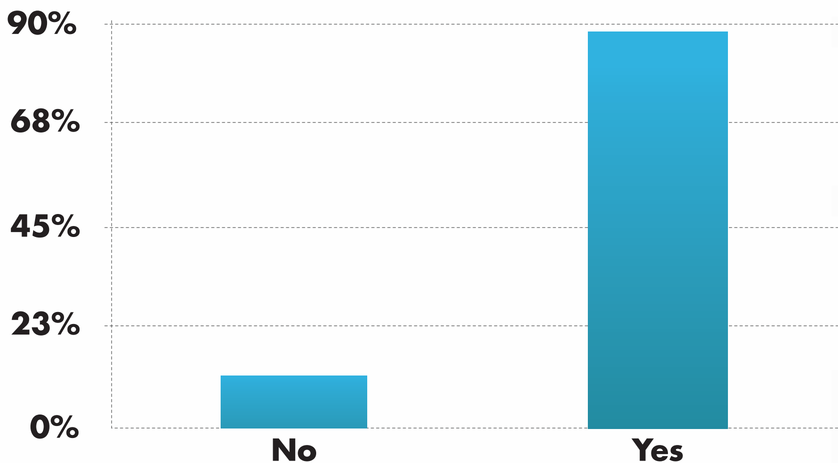
Removing Tax at Cessation of Employment is the Starting Point

Taxation of equity awards when an employee leaves a company has continually been highlighted as a key issue impacting the effectiveness of ESS schemes in Australia. It is raised in every consultation process related to the tax treatment of ESS and on an ongoing basis in our discussions with both private and major listed companies.

Question 1: Is removal of tax at cessation of employment the most important issue for you at the moment?

The below results show that it is a key issue for the majority of companies:

% of companies



The other issues that were listed were:

1. An increase in the $1,000 limit on the tax exempt plan.
2. The amount of tax that is currently payable on ESS (i.e it is too high) and the point of taxation should be at realization, i.e. when someone receives the awards.
3. Accounting treatment of indeterminate rights and cash or equity settled instruments.
4. Stability in this area.

Cessation of Employment - Why This is an Important Issue

Triggering tax on cessation of employment is often at odds with the commercial objectives of an ESS; for example, encouraging long-term share ownership by participants.

Cessation of employment is usually a trigger for employee plans to be taxed. So even if an employee contributes their own money through salary sacrifice (outside the tax exempt scheme) these plans trigger a taxation event for an employee when they leave their company. This happens regardless of the reason why an employee leaves and whether or not the employee may be able to immediately sell the shares. Salary sacrifice plans are usually offered to all employees and the current regime is a key inhibitor to helping an employee use the plan as a long-term savings vehicle.

Australia is the only country that has tax when an employee leaves their employment. It means employees need to sell their shares when they leave their company.

For other tax deferred plans (e.g., long-term incentive plans) cessation of employment may not trigger vesting of awards. For example, 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. Even in this case where the vesting happens later (and they have no access to the equity beforehand) employees can still be taxed at cessation of employment. Many companies have managed this issue by building in flexibility to settle incentive awards in cash of equivalent value ("indeterminate rights") – which allows the taxing point to be deferred until the time of payment (i.e., when the award eventually vests), rather than being taxed on termination of employment. Again, this is inconsistent with the objectives of an ESS where the delivery mechanism is intended to be company shares – not cash – and has introduced additional complexity into plans.

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 after cessation of employment. This results in individuals in difficult situations facing large tax liabilities at a time when they can least afford to pay the liability. As noted above, many companies have changed their plans to indeterminate rights to avoid unfavourable outcomes for their good leavers.

From a tax revenue perspective, if the taxing point was removed (so that participants are subject to tax only when they acquire, and can sell, the underlying shares), there would not necessarily be a fall in overall tax revenue. In fact, the total tax take could potentially increase. For example, where participants are subject to tax on ESS grants when ceasing employment, any future growth in value before underlying shares are sold would normally be subject to capital gains tax (CGT) – potentially attracting the 50% CGT discount. If, however, the taxing point only occurs on vesting / when the shares can be sold, the full amount of gain would be taxed at marginal rates, and the CGT discount would not be available.

In an environment where employees have more mobility and are likely to stay for shorter periods with one employer the current regime does not encourage long term owners or savers.

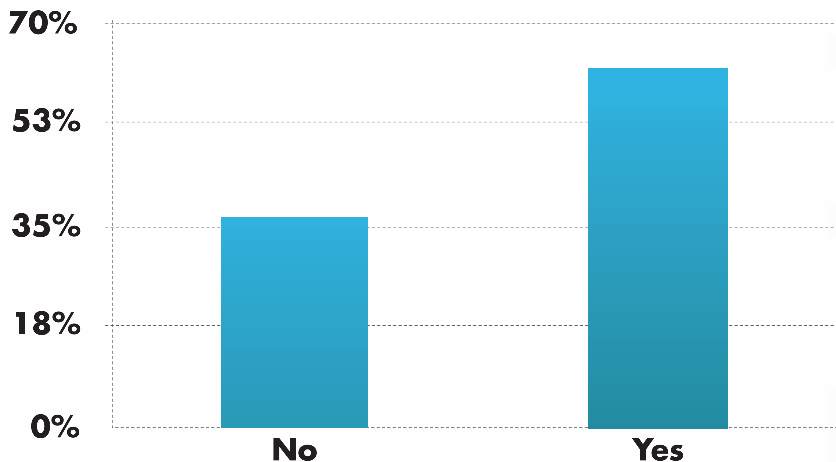
This provision also runs contrary to clawback requirements, good stakeholder governance and the Productivity Commission's recommendations in this area.

http://www.pc.gov.au/inquiries/completed/executive-remuneration/report

Question 2: If reform was developed that allowed good leavers only not to be taxed at cessation of employment would this solve the issue?

The results to the proposal of removing tax at cessation for good leavers ONLY were mixed:

% of companies



This is what some of the companies explained as the issue:
1. Largely companies saw it only as a starting point rather than an ending point, even if they agreed it was a partial solution, i.e. it is better than the current position.

2. The key issue was seen to be inequality between employees (i.e. broad based employee plans would be the worst effected, because the tax trigger inhibits long term savings and in a mobile population people who have saved under a salary sacrifice plan would be taxed if they retired).

3. It would add even more complexity because some employees would be taxed at cessation and other wouldn't. This would result in a number of things: greater administration and costs for companies; greater tax reporting complexity and with this real difficulties in communicating this complexity to their employees.

4. It could lead to real issues at cessation of employment, i.e. employees questioning if they are considered a good or bad leaver, it would add additional issues in separation discussions and potentially, because of subjectivity, greater employment litigation.

Despite the overall outcome the underlying commentary from companies was that a single regime for all employees is better and fundamentally tax at cessation of employment makes Australia more complex and out of line with the rest of the world.

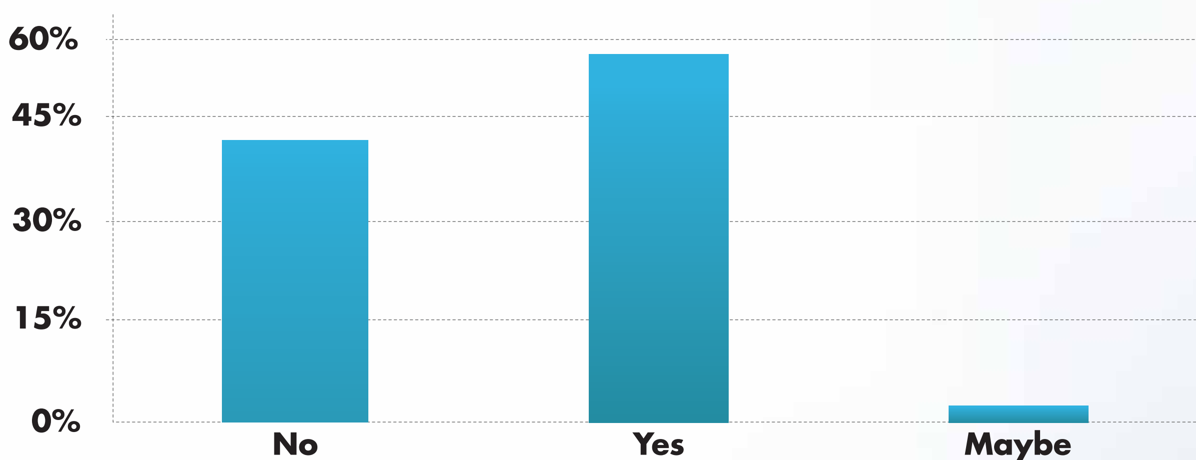
Could Withholding Tax be an Alternative?

Companies accept that in the current environment the changes around removal of tax at cessation could have a revenue impact because tax could be collected later for some employees. As a result of this there has been some discussion around whether withholding tax should be introduced to, in part, offset this cost. Withholding tax would ensure revenue collection happens. In some cases it would bring forward the collection, which is currently, post July ESS reporting, up to 18 months later for some tax payers.

Question 3: Another proposal is that tax at cessation be removed as a taxing point but as a concession and to overcome the potential cost of this there is a withholding tax at the taxing time, i.e. PAYG would apply. Under this arrangement, the employer would be responsible for withholding tax on the equity award and paying this to the ATO, similarly to how share plan tax is collected in most other countries. Generally, the tax is recovered by withholding amounts from salary or selling a portion of the equity award at vesting. Would you support a withholding tax regime for all ESS taxing points in return for tax at cessation being removed?

The results are set out below and shows that companies are divided about withholding tax:

% of companies



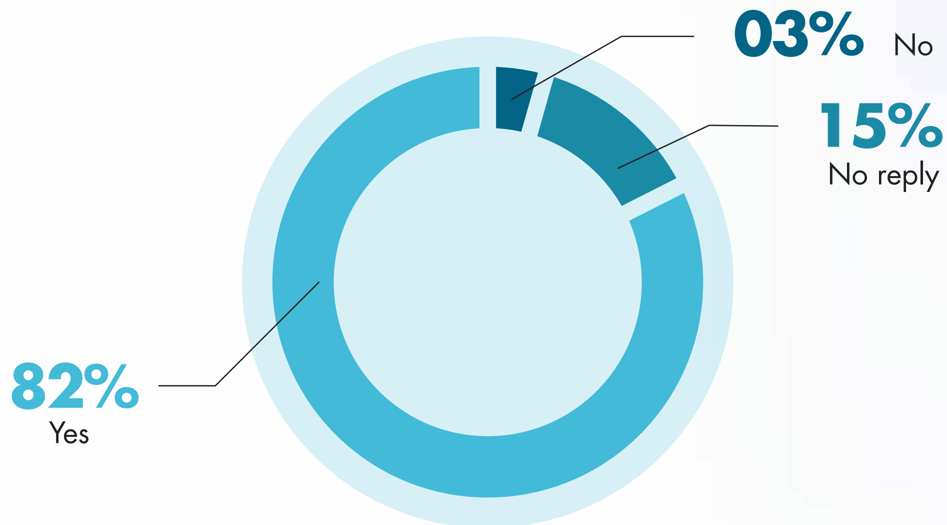
Companies' key concerns were additional costs and complexity – however, if they had global plans in place and were already required to operate withholding tax arrangements they had less concern about implementing a withholding regime in Australia.

Why the Tax Exempt Plan Needs To be Increased above $1,000

The tax exempt plan was first introduced in 1995 and in 1997 was increased to $1,000. Since then the limit has not been indexed or increased and the value of the plan has decreased significantly in real terms and also in the eyes of employees and employers.

Question 4: Should the $1,000 limit be increased?

The response was a significant "yes" response:



Question 5: If the $1,000 limit was increased would your company be likely to offer shares at the new limit?

We also asked companies if they would be likely to offer the plan if the limit was increased to see if an increase in the $1,000 would have an impact.

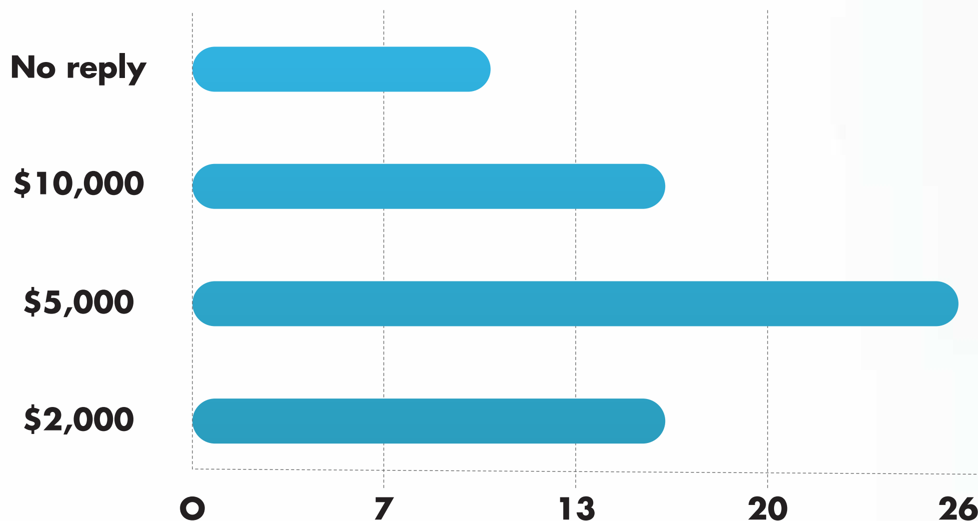
Most companies responded that they would use it:

Question 6: What should the new limit be?

We also asked companies what the new limit should be. Anecdotally this seems to be partly based on their experience of employees' needs and expectations in the current market place.

Most companies opted for an increase to a maximum of $5,000:

No. of companies



This change could be entirely revenue-neutral, if it applied only to tax exempt plans where shares are provided free, i.e. in addition to cash salary, rather than under a salary sacrifice arrangement where shares are granted in lieu of cash salary

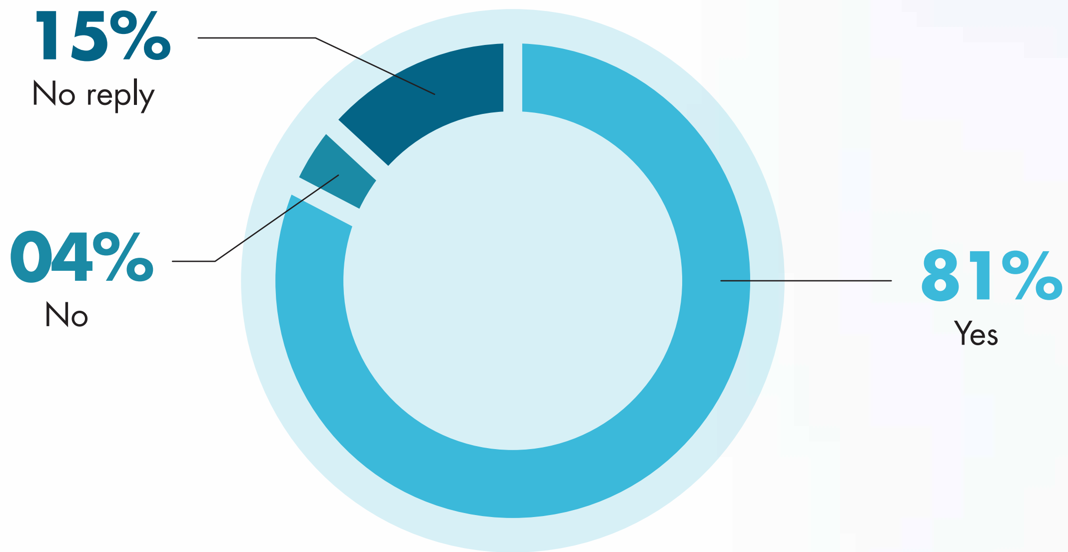
Salary Sacrifice Plan – The Route to National Savings

Salary sacrifice plans have commonly been used by the general employee population as a savings vehicle, that allows employees to start savings through pre-tax salary. Often employees enter the plan and then tend not to notice the reduction in salary. The plan then becomes a means for them to save over a long period. This has often meant that at the end of 3 - 5 years employees have a fairly significant shareholding that for some employees becomes a real boost to retirement or key life investments like a deposit for a house, education costs for their children etc.

Question 7: Do you believe the $5,000 salary sacrifice plan should be increased?

Before 2009 changes the salary sacrifice plan was unlimited and previous research has shown that the average take up was $10,000.

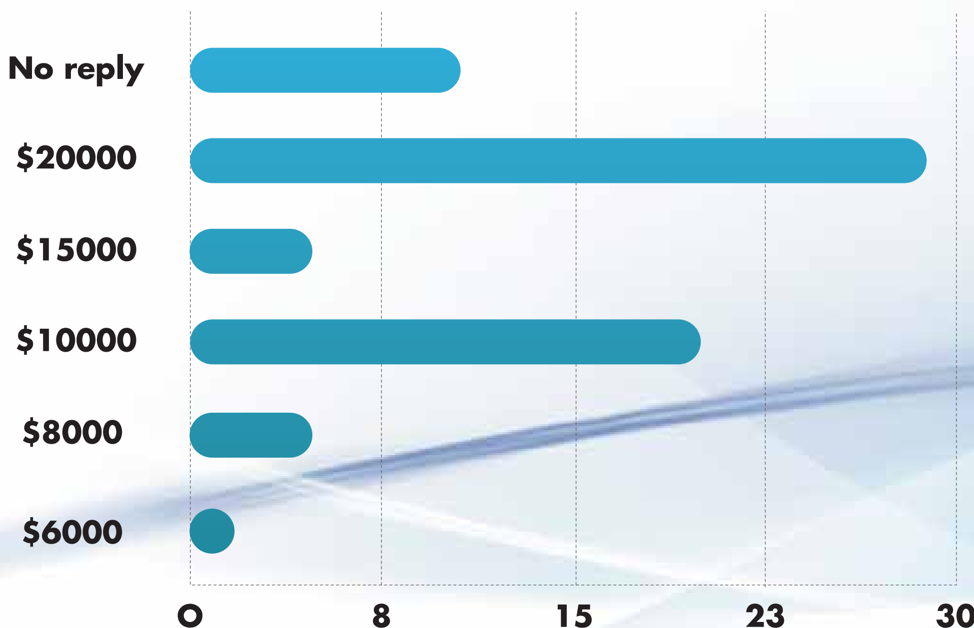
When we asked companies if the limit should be increased again the results were a quite significant yes:



Question 8: What should the new limit be?

Again we asked companies what they thought the new limit should be. The responses are shown below:

No. of companies



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.

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