Employee Ownership Australia *Making it your business*

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TO Committee Secretary | Standing Committee on Economics
Parliament House Office
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Submission on Inquiry into promoting economic dynamism, competition and business formation

Dear Committee Secretary

We understand the House of Representatives Standing Committee on Economics (‘**Committee**’) commenced an inquiry into promoting economic dynamism, competition and business formation on 31 January 2023 (‘**Inquiry**’). Submissions for the inquiry were required by 31 March 2023.

Unfortunately, we were not aware of the Inquiry and respectfully ask whether the Committee would be prepared to accept a late submission. If so, the remainder of this letter sets out our submissions in respect of the Inquiry.

We apologise for our oversight and the inconvenience this has caused the Committee.

1 Introduction

Employee Ownership Australia (‘**EOA**’) welcomes the opportunity to make a submission on the inquiry into promoting economic dynamism, competition and business formation.

EOA was formed in July 2011 to ensure ongoing advocacy for broad based employee ownership and dynamic workplace participation in Australian 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, and is the only independent, dedicated advocacy and education group in this space in Australia.

We advocate for tax and corporate regimes that promote, not prevent, the ability of business to engage in employee ownership.

These submissions set out the current barriers to promoting economic dynamism and the formation of new business structures in Australia.

There is an opportunity and need for employee ownership structures to be given further prominence in Australian policy development.

In EOA’s view it is appropriate that there be steps taken to facilitate advice and support programs for business which seek to engage in economic dynamism and convert their underlying business model to an employee ownership structure.

We welcome the opportunity to engage further with the House of Representatives Standing Committee on Economics in relation to our observations and submissions.

2 Opportunities and Challenges

2.1 Employee Ownership Structure Benefits

There are significant benefits associated with employee-owned business structures.

As noted in the House of Representatives Standing Committee on Tax and Revenues report dated August 2021, '*Owning a Share of Your Work: Tax Treatment of Employee Share Schemes*' ('***ESS Report***') employee-owned business structures provide important benefits to both individuals, employers and the economy.

Encouraging greater retention and attraction of talent

Employee-owned business structures encourage greater retention and attraction of talent. This is particularly apposite in the context of dynamic, start-up tech companies where the industry is plagued by fierce competition for talent.

One way of securing and attracting talent is the provision of equity/option packages as part of an employee's renumeration. For instance, employee ownership schemes enable start-up companies to attract and retain talent at a point when such start-ups lack credit and are often, cash poor.

Generating higher productivity

Employee ownership structures generate higher productivity as employee incentives align with that of their employers. The Department of Industry, Innovation and Science's review of the performance and characteristics of Australian firms previously noted that 75% of surveyed businesses agreed that employee ownership share schemes have increased productivity.[1]

This is unsurprising given that employee ownership structures provide employees with a share of the profits of the business, thereby boosting employee remuneration and in turn, facilitating greater engagement within the business.

Fair distribution of economic gains

Traditionally, successful high-growth private businesses regularly deliver polarised wealth to its founders. By increasing company ownership more broadly amongst employees, economic gains may be distributed more evenly. In turn, economic value may spread through to the broader Australian economy.

2.2 Business Formation Opportunities

There is an increasing global move to enhancing employee-owned structures.

The United States Labour Department recently announced that it was launching a 'Division of Employee Ownership' in accordance with a congressional directive to promote worker-owned companies.[2] The Division will support the creation and expansion of worker-owned businesses by:

(a) supporting existing programs designed to promote employee ownership and facilitating the formation of new programs;

(b) providing education, outreach, and training to inform employees and employers about the possibilities and benefits of worker ownership and business ownership succession planning; and

(c) providing technical assistance for employee's efforts to become business owners and helping employers and employees explore the feasibility of transferring full or partial ownership to employees.

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[1] Department of Industry, Innovation and Science, 'The Performance and characteristics of Australian firms with Employee Share Schemes', July 2017, p. 4. See also Ingrid Landau, Ann O'Connell and Ian Ramsay, Incentivising Employees: The theory, policy and practice of employee share ownership plans in Australia, February 2013.

[2] See, Department of Labour launches initiative to promote worker-owned businesses, increase workplace democracy, improve bottom line for many Americans | U.S. Department of Labor (dol.gov).

Similarly, following the 2012 report by Graeme Nuttall, "*Sharing Success: The Nuttall Review of Employee Ownership*" (‘***Nuttall Report***’), the United Kingdom introduced specific enabling legislation to promote employee ownership and business structures. In particular, the legislation provided a specific regime to accommodate the use of the ‘employee ownership trust’ structures. Set out in **Annexure A** is a summary of a form of an employee ownership trust.

Since the introduction of the enabling legislation, the United Kingdom has experienced a significant growth in the number of employee ownership trust enterprises. For example, the total number of employee-owned businesses is now at 1,418 which equates to a 37% increase on the number recorded in 2021.[3]

A similar regime has been announced in Canada as part of the Government’s March 2023 budget which proposes to introduce new rules to facilitate the use of employee ownership trust structures.[4]

In Australia, much of the corporate and tax regulation is associated with the prevention, rather than promotion of employee ownership structures. Unfortunately, it is common knowledge amongst industry pundits that the current tax rules in Australia are not as attractive for their company to grow its footprint in Australia as they are in other jurisdictions around the world.

2.3 Facilitating Effective Business Succession for Small-Medium Enterprise

Business succession is a major issue for many existing small to medium size enterprises.

In Australia, it is expected that some 77% of baby boomers are expected to exit their businesses within the next ten years,[5] which is likely to require a form of business succession.

In many cases, business succession for existing small to medium size enterprises includes a form of corporate consolidation as they are often acquired by a competitor in the market.

This may not be a preferred exit mechanism for many existing small to medium size enterprises. The founder of the enterprise may be keen to see the continuation of the enterprise in its existing form. Employee ownership structures can provide an effective and appropriate mechanism for business succession. It allows for succession to be achieved without a form of corporate consolidation.

In many cases, it also allows for the continuation of the operation of small to medium size business. Whilst we acknowledge that it is not an appropriate outcome in all instances, in our experience, many businesses struggle with succession and are seeking to adopt a form of employee ownership.

The current corporate and tax regimes make that form of conversion difficult or not capable of being achieved. The development of an employee ownership trust is particularly important in this context. It has been a key tool in the United Kingdom to achieving effective and successful business succession for many existing small to medium size enterprises in the United Kingdom.

2.4 Corporate and Tax Regulation Challenges

There are significant and unnecessary limits on particular types of business structures, including include employee ownership being formed and maintained. This is a result of both current corporate and regulatory rules.

One particular form of business structure which is affected by these limitations is the ‘employee ownership trust’. It is a structure commonly used in the United Kingdom. We have set out at **Annexure A**, a summary of this type of employee ownership structure.

However, as noted, there are a series of difficulties associated with the provision of employee equity in small to medium size enterprises. Although these difficulties seem minor, they have a

[3] See, Employee-Owned Sector Growth | What the evidence tells us (employeeownership.co.uk).

[4] See, Chapter 3: A Made-In-Canada Plan: Affordable Energy, Good Jobs, and a Growing Clean Economy | Budget 2023.

[5] See the survey conducted by William Buck Exit Smart, as reported in the Australian Financial Review: Baby Boomers head to the exits (afr.com)

significant and adverse impact on the ability to provide employee equity to employees in small and medium size business.[6]

By way of summary, the major concerns are:

(a) Anomalies in the form and administration in corporations law which regulates the offer of equity to employees

These anomalies continue notwithstanding the improvements which were made to the corporate rules dealing with relief from the prospectus rules for employee share scheme offers.[7] There remain aspects of the law that are unnecessarily complex and arbitrary in their application.

(b) Anomalies in the conditions for satisfaction of start-up concessions

Some of these anomalies were noted in the ESS Report. These anomalies include, for example, the fact that a newly established business in a company incorporated 10 years ago would not qualify for the concession. In contrast the same newly established business in a new company would qualify. This is despite there being (in substance), no difference in outcome.

(c) Unnecessarily complex valuation rules

There are concessional valuation rules for the offer of employee equity associated with the so-called 'start-up concession' for employee share schemes.[8] These rules should be extended to apply to small-medium size enterprises which offer employee equity.

(d) Unnecessary complexity in relation to the restriction on providing limited recourse/ interest free loans to fund the acquisition of employee equity.

These restrictions are contained in Division 7A in respect of loans made to employees who are existing shareholders.[9]

These issues are further exacerbated by the unnecessary restriction of the relief provided under the corporations law rules for loan schemes to employees who are not existing shareholders.[10]

(e) Inability to provide small to medium size enterprise with the opportunity to take advantage of the employee ownership trust structure in Australia

This is restricted because there is currently no public guidance provided by the Australian Taxation Office ('***ATO***') in relation to this form of structure. We are currently in discussions with the ATO to examine the potential for public guidance to be provided.

We believe that it is likely that the ability to adopt employee ownership trusts could be enhanced by some simple legislative concessions.

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6 See for instance the House of Representatives Standing Committee on Tax and Revenues report dated August 2021, '*Owning a Share of Your Work: Tax Treatment of Employee Share Schemes.*

7 The *Treasury Laws Amendments (Cost of Living Support and Other Measures) Act* amended the *Corporations Act 2001* (Cth) (Act) earlier this year to insert a new regime for employee share schemes, which will take effect on and from 1 October 2022. These anomalies continue, and, in some cases, are exacerbated by the form of ASIC instruments issued in relation to the changes to the corporations law. ASIC Corporations (Employee Share Schemes) Instrument 2022/1021 and ASIC Corporations (Amendment) Instrument 2022/1022.

8 See Legislative instrument ESS 2015/1 made under subsection 960-412(2) of the *Income Tax Assessment Act 1997.*

9 The exclusions from the provisions in Division 7A deem a loan to a shareholder to be a dividend contain specific exemptions for loans associated with some share schemes. It excludes some, but not all employees shareholders. The exclusion contained in section 109NB is too narrowly expressed.

10 There is an exclusion from the corporation law rules requiring a prospectus in respect of certain employee shares acquired by a form of complying loan. That concession is inappropriately limited to loans to employees, who are not shareholders. It is based on a misconception that loans may not be made to employees which are shareholders for tax reasons. This is incorrect outcomes. See the exclusion in s 1100U(2) of the *Corporations Act 2001* (Cth).

We anticipate that these could be provided without any loss of integrity to the tax system and are also capable of being introduced in a form which is revenue neutral.

3 Key Recommendations

Our key recommendations are that steps should be taken to promote and facilitate employee ownership business structures.

We believe that employee ownership business structures benefit the economy as they promote and sustain the development of small to medium sized business in Australia.

Our specific recommendations are as follows:

Recommendation 1

The establishment of an equivalent body to that which operates in the United States to promote employee ownership structures.

It is intended that this body would work with the ATO and the Australian Securities and Investments Commission (**'*ASIC*'**)to:

- Investigate how the usage of employee ownership structures can be facilitated and encouraged in Australia;
- Raise public awareness to inform current and potential business owners of the existence and benefits of employee ownership structure, and where and how to access the available resources; and
- Publish up-to date data on employee ownership structure usage in Australia.

Recommendation 2

Conduct a review of the tax and regulatory rules to ensure that they promote employee ownership structures.

It would be prudent to explore the structure of employee ownership structures and their related taxation treatment in other countries, and how this could be adapted to the Australian taxation system to support productivity and innovation.

However, we believe this can be achieved without corporate or taxation integrity issues.

Recommendation 3

Formal recognition of the benefits of Employee Ownership trusts to enhance awareness and ease of access to the EOT structure in Australia.

It is intended that as part of **Recommendation 1**, the newly formed body will investigate the usage of EOTs, including exploring their benefits in the Australian economy.

Recommendation 4

Conducting ongoing reviews to ensure that where tax and regulatory burdens exist in relation to the development of employee ownership structures, they are able to be brought to the attention of government to enable appropriate legislative response.

It is intended that as part of **Recommendation 1**, the newly formed body will continuously review the development of employee ownership structures and liaise with the ATO and ASIC to explore solutions to any tax or regulatory issues.

Recommendation 5

Development of a 'one stop approach' to employee ownership structures.

It is intended that as part of **Recommendation 1**, the newly formed body will provide a 'one stop shop' which provides greater assistance in the provision of simple, standard documents to facilitate conventional business structures. The intention is to provide businesses with all the information they require to transition to an employee ownership structures, and to prevent unintended non-compliance.

If there are any queries arising from these submissions, please contact Andrew Clements, Chair of Employee Ownership Australia

Yours sincerely

Andrew Clements

Chair of Employee Ownership Australia

Annexure 1 Employee Ownership Trust Structure

1 EOTs in Operation

The purpose of **Annexure 1** is to set out a type of employee ownership structure called an 'employee ownership trust' ('**EOT**').

An EOT is a structure that is used to facilitate employee ownership of a company. Essentially, the trustee of the EOT holds a long term, significant sized shareholding in an operating company for the benefit of employees.

The structure does not depend upon specific shares being held by particular employees from time to time and no employee has any particular entitlements to any shares in the operating company. Rather, the EOT holds its rights and shares for the benefit of all present and future employees of the company. Accordingly, as beneficiaries of the EOT, the employees are indirect owners of the company.

The trustee of the EOT takes on a custodial role in relation to the conduct of the company and therefore has the power to exercise its share rights to ensure the underlying operating company is a successful, independent professionally managed trading company with an employee ownership ethos.

1.1 Operation of the EOT

The EOT operates through a series of contractual arrangements which entrench the rights of the employees. These arrangements generally include an agreement between the company and the EOT which sets out the information and notification rights, as well as the matters over which the EOT may veto ('**EOT Agreement**').

The specific scope of these rights can be fine-tuned according to what is considered appropriate according to the circumstances of a particular business. Generally, the EOT will have direct veto rights over matters such as changes to the employee bonus plan, significant changes to the business plan or operating model, and changes to culture (i.e., through changes to a statement of values). The EOT Agreement facilitates the EOT's ability to influence the operating company.

1.2 Nature of Employees Interest

As the EOT exercises rights for the collective benefit of the employees, the underlying trust deed includes an equal representation provision. This provision provides that the benefits which accrue under the EOT accrue for the employees equally. Hence, the EOT provides benefits to the employees on a non-discriminatory basis.

There is no fixed or specific entitlement of an employee to a particular asset of the trust or interest in the trust. The economic benefit from the conduct of the business is passed on to the employees under a type of cash bonus plan. Generally, payments are made by the company to employees as a cash bonus.

The cash bonus plan can be entrenched by way of the Agreement with the EOT and can provide for particular entitlements for employees by reference to specific criteria such as period of service, level of seniority and team performance.

1.3 Employee Rights

The rights exercised for the collective benefit of employees are generally in relation to:

- access to information;
- rights to seek information;
- the requirement for the EOT to consent to certain significant corporate events; and

- to entrench the employee bonus arrangements and the employee ownership ethos.

An EOT model is generally predicated on seeking greater employee representation and, in addition to the creation of an EOT and exercising the rights outlined above, may include:

- appointment of employee representatives to the board of the operating company;
- creation of an employee council to provide a forum for enhanced employee engagement. This council may be responsible or engaged in the appointment of employee directors to both the operating company and to the trustee of the EOT; and
- entrenchment of an employee ownership ethos and broad-based equity like cash bonus arrangements.

1.4 Acquisition of Shares by EOT

In Australia, it is common for shares to be acquired by way of:

- the acquisition of a small number of shares by the EOT; and
- the company conducting a share buyback programme over a number of years in which founders of the company dispose of some or all of their shares. As a result of share buy back the proportion of shares that the EOT owns will increase

The shares would be held on an unallocated basis for the employee beneficiaries of the EOT. The shares held by the EOT are not allocated to particular employees. The interest of the employee is as a mere object of the trust and there is no fixed or specific entitlement of a participant to a share in the company.

1.5 Administration of EOT

The EOT is administered by the trustee who is generally a company limited by guarantee. It is not recommended for a professional trustee company or a funds administrator to take up this role.

Rather, EOA’s position is that the Board of the EOT would generally be comprised of some of the existing shareholders or directors, representatives appointed by the employee council and an independent chair.

The administration of the EOT is essentially the exercise of the powers vested in the EOT either by virtue of direct share ownership or by virtue of the incidental influence rights vested in the EOT via the EOT Agreement. The major changes to the operation of the company derive principally from the increased level of engagement of employees in the management and disclosure of information. The extent of these changes depends on the nature of the obligations which will be determined as part of the development of the arrangement and the terms of the control rights vested in the EOT.

1.6 Arrival and Departure of Employees

As the EOT retains the long-term shareholding and does not hold any specific interest for individual employees, the arrival and departure of employees does not raise any issues nor require any specific changes to the administration of the EOT. There is no need for each generation of employee to pay for their ownership stake or sell their stake upon exiting the company.