Succession ESOPs

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Introduction

The two major issues facing the owners of private companies looking to retire are how to enable the company to continue growing, and how to realise the value of their shareholding without a ready market for the shares. Having built a company the founders generally like to see the company continue to operate and even grow after their retirement so that:

a) Their legacy can continue, with founders often being passionate about the company,
b) They may receive dividends while they continue to hold shares,
c) They can monetise the value of the shareholding by selling down their shareholdings as the opportunity arises.

In addition, employees who have helped build the business are motivated to continue growing the business instead of being made redundant which would occur if the company were to be closed. Key employees can have the opportunity to buy into the company and increase their participation as a shareholder, motivating them to grow the value even as the founder sells down.

Even when companies are successful, shareholders do not have an opportunity to sell their shares or the business because either the company is too small to warrant an initial public offering of shares (IPO) via a listing on a stock exchange or a trade sale to another organisation is not available. Thus, the shareholders need to be proactive in setting up a plan through which the founders can sell-down their shares to employees. This type of situation is referred to as succession and the type of plan that is used is a Succession Employee Share Ownership Plan (SESOP).

Reality Check

There are a number of realities that apply to shareholders in private companies, and they will generally need to apply to employee shareholders who may end up holding shares through SESOP participation (though this can often be many years after first SESOP participation). Of particular note:

1. Shares in private companies are not easily sold because there is no readily available market in which to sell shares. To overcome this problem, some companies undertake listing of their shares on a stock exchange. However, a stock exchange listing of shares is complicated, costly and involves significant ongoing costs that are not incurred by private companies. This approach is also often only available to companies of exceptional scale, rather than the “SMEs” (Small to Medium Enterprises) that characterise most of the Australian market.
2. Most private companies have a shareholder agreement which govern all shareholders and aims to ensure that:
    a. new shareholders are acceptable to existing shareholders,
    b. if one shareholder has found a willing buyer of their shares, the other shareholders are offered a similar opportunity to sell, and
    c. if the majority wish to sell and the prospective buyer wishes to acquire 100% ownership then a shareholder who is unwilling to sell must abide by the wishes of the majority of shareholders.

3. Because of the foregoing, shareholders in private companies need to accept that they may be locked into their ownership position for many years.
4. Private company shareholders are likely to be paid dividends (which may be franked) from the annual profits of the company. For employees who are also shareholders this means that their income from the company will be larger than received by employees in comparable jobs.
5. Shareholders are entitled to have access to the company's financial records and to vote with their shares. However, with the use of a trustee to hold shares this access can be curtailed, if necessary. This can also delay or prevent smaller entities from tipping over into Public Company status (because the trust is viewed as a single shareholder), which brings with it a range of obligations that are often avoided by SME shareholders.
6. Employees generally do not have available, or access to, sufficient cash funds with which to buy shares from founder-shareholders.
7. Loans from the company are not a suitable means of financing the purchase of shares because once an employee also becomes a shareholder such loans are treated as dividends for taxation purposes in the hands of the employee. Thus, they may generally be used once only for each employee.
8. Salary sacrifice is limited due to regulatory restrictions for most employees and is not available for employees who are paid award wages. For others in award governed roles, it is available to the extent that their pay exceeds award wages.

An appropriately designed SESOP can overcome most of the perceived impediments to the transfer of company ownership to employees.

Myths Dispelled

There are several myths that circulate in relation to Employee Share Ownership Plans (ESOPs), including SESOPs, which are not correct when a properly structured SESOP is established. These myths include:

Myth	Comment
1. All employees with 3 or more years of service must be offered participation in the ESOP.	Participation in an ESOP can be limited to a selected category of employees and can be limited to senior executives only.
2. Salary sacrifice must be limited to $5,000 per annum for each employee.	This is true for one type of plan, but in practice the main limit for contribution plans is under the Corporations Act and restricts total offers to 20% of issued shares over 3 years. A properly structured SESOP is not a contribution plan and these limits do not apply.
3. Employees who own more than 10% of issued shares are taxed up front when shares are acquired.	Properly structured plans can offer tax deferral benefits or Capital Gains Tax (CGT) benefits with no tax being paid up-front.
4. SESOPs that use employee share trusts (ESTs) are governed by trust law rather than the Corporations Act.	This is not true. Generally, offers of shares and financial products are subject to onerous compliance requirements unless the plan falls under specific provisions which apply to all types of SESOPs.
5. Annual independent company/share valuations are required.	Valuations can be needed from time to time for taxation purposes, but not every year and possibly only in exceptional circumstances.

6. Employees cannot fund their tax liabilities arising from equity remuneration.	This can be true if the SESOP is improperly designed and results in up-front tax, or if there is no option to cash-out equity at the taxing point, which can be flexible and up to 15 years after receipt.

Objectives of a SESOP

The objectives of a SESOP include:

1. Creating a market for founders to sell into, allowing them to gradually realise capital gains over time (spreading out taxable income peaks).
2. Funding the transition of ownership from proceeds of the business by converting cash and long term incentives into equity acquisitions.
3. The allocation of funds with which shares may be purchased from founder-shareholders.
4. Funding to be from pre-tax remuneration so that tax is deferred and the funds available for share purchases is maximised.
5. Funding to be from market competitive total remuneration packages, not extra remuneration unless the founder-shareholders wish to provide additional reward for past service or work contribution.
6. Shares to be held long term as there is no ready market for shares in private companies.
7. Company to fund cash-in of shares by employees, where possible, given cash flow constraints. As a minimum the company should endeavour to provide cash for 50% of the shares, employees wish to cash-in to allow them to pay their tax liabilities.
8. Shares to be held on similar terms to those that are contained in the shareholders' agreement, if applicable.
9. Employees to accumulate significant shareholdings over time and possibly acquire all shares from founder-shareholders.

If employees have personal funds or can access funds to invest, then the SESOP should not impede their ability to buy shares from founder-shareholders. There may be many reasons why a founder-shareholder may prefer not to sell to an individual employee, particularly if they are not the CEO.

Employees who take personal ownership of shares generally need to enter into the shareholders' agreement that binds other shareholders.

Simple SESOP Design Features

The following features relate to a simple design that meets the objectives of a SESOP. These features may be modified, but there may be implications that flow from making changes which should be the subject of professional consultation.

Design Aspect	Description
Incentive Remuneration Plan	A revised or new incentive remuneration plan is set up for those employees who will be offered participation in the SESOP. The incentive plan should be designed to deliver market competitive total remuneration packages when target performance is achieved i.e. no additional remuneration, only the form changes. Awards under the incentive plan should be structured such that low or nil awards arise when performance is significantly below expectations and high awards arise when performance exceeds expectations. Higher awards are, in effect, self-funded.
Payment of Incentive Awards	Incentive awards are paid fully or partly in equity interests in the company. Such awards are not taxable income of the employee when received (up to 15 years delayed, flexibly).

Design Aspect	Description
Contributions	The value of the incentive awards is paid as a contribution to an EST. The company will receive a tax deduction for the value of the contributions when the amount matches employee incentive outcomes. Employees are not taxed on the contributions.
Share Purchases	The EST uses the contributions to buy shares from founder-shareholders at market value. Market value of shares is calculated using a simple formula agreed with the founder-shareholders and Board. The formula should produce a fair market value for the shares. This can be expected to be accepted by the ATO for founder CGT calculation purposes, and should avoid the need for formal valuations, assuming the approach is not blatantly discounted. As share acquisitions occur annually the value of each employee's equity interests in the company will accumulate over multiple years.
Accumulation of Shares	The shares are held by the EST while the employee remains employed. This allows employees to accumulate significant shareholdings which attract annual dividends and grow in value, if the company's performance improves.
Dividends	Dividends received by the EST are passed on to the employee for whose benefit the shares are held. Employee is taxed on the dividends and receives the benefit of franking credits, if any.
Access to Value of Shares	The value of shares will either be paid to an employee, or the shares will be moved into the employee's control, when the following events occur: a) The 14th anniversary of the shares being acquired for the employee, b) Cessation of employment, c) The employee requesting and the Board approving, that shares be released early (a rare event but designed to help employees needing access to the shares). Often the settlement involves partial cash payment in lieu of shares, or as a buy-back, to enable employees to pay down tax that arises at that time, which can be delayed over a number of years, planned for and funded from company profits or as part of acquiring shares in the trust for new participants.

Conclusion

When facing retirement, founders of SMEs often feel like they have to choose between finding a trade sale partner, which rarely reflects the true value of the business, or closing the business - both of which tend to lead to sub-optimal outcomes for employees and destroy the legacy. Instead, a SESOP provides an effective market for founder equity while ensuring continuity for employees, and for the legacy that the founder has created. It can also often represent the best financial return for the founder, since it will tend to spread out the taxing point, and the value of the business can continue to grow as the sell-down occurs, with employees being highly motivated to further improve business performance to maximise their acquisition rate, and to maximise the value of the interests they have already acquired. For these reasons, a SESOP is likely the best exit strategy for most SME's that are not expecting an IPO, private equity buy-in, or trade sale into a hot market.