SUCCESSION

# REMUNERATION AND INCENTIVE PLANNING

How to get your employees to think and act like business owners

For many businesses, attracting, retaining, motivating and rewarding employees are key issues that can be the difference between success and failure. It is also a vital issue for any potential buyer (internal or external) and has a direct impact on business risk, and also value.

As part of our strategic advisory work with clients, we are able to offer a range of solutions to manage these issues and provide easy to implement solutions for business owners to encourage employees to think and act like business owners.

Salary Benchmarking. It is often difficult to determine what salary should apply to each employee especially for more senior people and especially in smaller privately owned organisations where employees might fulfil several senior roles. Our salary benchmarking data allows us to provide guidance as to the most appropriate salary applicable to your senior executives (or to family members).

Salary Packaging. Providing tax effective salary packaging options for your employees can greatly enhance their take home pay without costing the business any more, but the rules are complicated and you need to manage this aspect carefully to ensure you or your employees are not penalised due to poor management of salary arrangements.

Bonus Plans/Incentives. A lot of bonus and incentive plans are quite poorly designed and damaging to the business as well as being a disincentive to the employees. Many are not self-funding and end up costing the business owners more. There is often a disconnect between incentives and real performance, even less connection with real business outcomes. Properly designed plans are self-funded, driven by key business outcomes and KPIs and improved performance which drives the plan (and ultimately increased profit/reduced cost) provides funding for the incentive plan.

Harrison Assessments. Harrison Assessments allow your business to work toward milestones by identifying limitations and opportunities within your current team. The evaluation allows you to maximise company performance by establishing the areas where training is needed or where skills can be more effectively leveraged.

Employee Engagement. A lot of business owners are looking for better ways to engage employees and have them more involved in driving the performance of the business. Our tools are geared towards creating and rewarding an “ownership thinking” culture with engaged employees thinking and acting like business owners. Employee Share Ownership Plans (ESOPs): A lot of research is available clearly demonstrating the value of equity plans to attract, retain and motivate key employees. We use several models to achieve effective outcomes.

## LADDER TO EQUITY

A simple mechanism to manage the transition through various stages is this issue. It is not simple, nor smart, to simply take an employee and provide them with equity – and thus the ladder becomes important.

> "Employees are keen to climb the ladder to equity, but someone needs to provide the ladder." – Warren Buffett

*PROGRESSIVE STAGED APPROACH*

Employee Earnings → Income Model → Profit Share → Equity → Control

1. **Employee Earnings**. Earning (salary/wage/hourly rates etc.) – This is where most employees start (and stay).

2. **Income Model.** The first step on the ladder then is to boost that income and this is quite common. We often see companies paying bonuses, commissions on sales, incentives etc. to increase an employee's income. This is a great step to link performance with reward.

3. **Profit Share.** Most equity plans begin with this simple step and in fact many end at this step. Simply providing a share of profits to employees is a great additional incentive as they are directly rewarded as a result of the financial performance of the company in the same way that a business owner typically would be. This step changes the focus from personal to team performance.

4. **Equity**. Whilst there are many equity plans available, our models provide formal structured mechanism to incorporate stages three, four and five into any business succession plan. This allows employees to transition into an equity ownership position within the business they work for and encourages long-term strategic thinking.

5. **Control**. Often this step is never utilised though on occasion has substantial benefits in terms of succession, not only of ownership but also of business management. Ultimately, control means that employees can be transitioned through the earlier four stages and end up in a position of control. This may be that they take over general management or CEO of the company, it may be that they end up with a seat on the board at some future date however, this step is not to be rushed.

If managed correctly, the ladder is a great methodology to identify opportunities to progressively transition employees to **think and act like business owners** and motivate key employees in the long term. Note however that the transition should be managed carefully with KPIs and performance criteria to proceed up the ladder. Such plans can fall over without logical steps listed out for employees or where businesses miss steps trying to fast track progression.

## Profit Share Plan Outline

A profit share plan has the advantage of focusing employees on one of the key issues for business owners - improving profitability. Aligning business owners and employees focus, by sharing a percentage of profits with employees, will create efficiency and often also reduce costs simply by getting employees to think and act like business owners. There are many models which could be utilised. We prefer an element of retained bonuses, to also encourage employee retention.

### Income

The plan should be focused on a profit share model, typically a % of profits achieved over and above a base/benchmark level (which represents the base investment return for owners). For example, if the profit benchmark was $250,000 (which is determined by financial modelling and review of past and projected performance), then any profits over and above this amount are shared with employees – typically anywhere from 20% - 50% of profits are shared with employees (above the benchmark level).

The profit share plan is typically paid annually (though could be done more often if required). In most plans, we recommend the employer retains a % of the profit share bonus for 12 months to encourage employee retention. For example, employee A earns a profit share bonus of $8,500 and $4,250 is paid today and $4,250 is retained for 12 months (and only paid if the employee remains with the business).

### Equity

Profit share plans do not normally include an equity component and are paid out in cash to the employee (this is generally taxed at normal marginal tax rates). Several of our clients have transitioned from an income focused plan (profit share) to an equity plan (Employee Share Ownership Plan or ESOP) and simply used the same profit share model to fund employees purchase of equity. This model can have taxation benefits and increases employer/employee alignment and encourages longer- term behaviours and focus.

### Control

Profit Share Plans (and most ESOPs) do not involve a change of control or management, but there is a large amount of academic research which shows employee involvement and engagement in management can improve outcomes and performance.

What many small and medium-sized businesses don't fully appreciate is how their remuneration practices influence the thinking, behaviour and performance of their staff. The way companies choose to pay their employees communicates their values and contributes enormously to the organisation's culture, the type of people it attracts and the results they deliver.

Consider the example of a business that only pays its people a standard wage, for a standard working day. What does that communicate? It says that nine-to-five thinking is all that is required, and that anything outside of that comes at an additional cost in the form of overtime. Do you think these staff are staying back to get the job done, thinking about work outside of their standard day or delivering any more than a standard performance? Probably not. What about a company that pays bonuses or commissions to individuals for monthly or quarterly results? This system communicates the message that it's everyone for him or herself and that people's focus need only be on the next bonus or commission timeframe.

## Employee Share Ownership Plans

***Employee Share Ownership Plans, or ESOPs***, are a mechanism used to allow employees to own the company they work for, with the express intention that they will think and act like business owners.

The primary objective is to create a structure with which employees' lifestyle and financial goals are aligned with business objectives. The result? A cohesive and committed team that is single-minded about working toward and sharing the benefits of a successful and profitable business.

ESOP companies have improved performance, higher profits and better staff retention than other businesses. The ability to attract, retain and motivate people to peak performance means being able to attract and retain business – and it is a major source of competitive advantage. In fact, it can mean the difference between success and failure.

ESOPs are used for several reasons:

- Savings Vehicle. Most ESOP plans have a long-term focus (3 – 7 years), allowing employees to accumulate savings through acquiring and holding shares.

- Participation. ESOP participants tend to experience a greater sense of community and involvement with the decision-making process, leading to increases in employee engagement levels.

- Succession Planning. An ESOP can be an effective employee buy-out instrument when the owner(s) want to retire (or change their business direction) and need to sell.

- Funding Retirement. ESOPs can give founders the ability to extract cash prior to retirement.

In July 2015, the federal government introduced new measures to encourage and promote the use of ESOPs.

*"We have designed these changes to increase the international competitiveness of our tax system and allow innovative Australian firms to attract and retain high-quality employees in the globally competitive labour market."* - Bruce Billson, Small Business Minister Australia)

As part of the government's Industry Innovation and Competitiveness Agenda, new legislation was introduced in July 2015 to simplify Employee Share Ownership Plans and to encourage greater utilisation of ESOPs in Australia.

### Summary of key Changes to Legislation

- Amendments to tax law in line with the federal government's $400 million Industry Innovation and Competitiveness Agenda.
- Reversal of unfavourable rules surrounding ESOPs introduced in 2009.
- Tax concessions for start-ups. Australian companies turning over less than $50M and less than 10 years old are unlisted.

## What does the research tell us about ESOPs?

Companies with high degrees of employee ownership tend to:

- Grow faster
  - Companies owned more than 10% by their employees outperform FTSE All-Share companies, the UK Employee Ownership Index shows.)
- Live longer and ride out hard times
  - E.g. John Lewis Partnership, founded in 1929, right before the Great Depression
- Attract better paying customers
- Contain better workplace cultures
  - Publix – 88 years, not a single layoff
- Workers tend to be better off.
  - In Australia, an employee with an employee owned firm has around 2.5x the net assets of employee in non-employee-owner firms.

Computershare's April 2018 research suggests that companies with an ESOP retain staff for 9.69 years on average, vs the 5.69 years staff serve on average in non-ESOP companies.

Australian ESOP adoption rate is low but is growing rapidly:

- 5.9% in Australia
- 7% in UK
- 10% in US
- 23% in France

In a sample of 131 listed companies in Australia, they went from 1.5% ESOP take-up, to 21.4% by 2000 and 77.10% by 2017.

Rutgers University research shows that to get the full benefits of employee ownership, it must be coupled with high-participation and high-performance policies, which include information sharing, teamwork and low supervision.

Performance increases ranging from 7-23% have been recorded at companies that get this mix right.

*Generally known amongst business writers and consultants: the open sharing of information is a superior organisational structure that typically contributes to longer term financial success".*
*- Scott Miller*

## Types of Employee Share Ownership Plans

1. **Start-up ESOP Plans**

   These plans have been introduced by the government as part of the government Industry
   Innovation and Competitiveness Agenda and are simple to set up and use. They also have
   significant tax advantages for participants:

   - No upfront tax.
   - No tax at vesting.
   - No tax on exercise.

   Participants are generally only taxed on disposal of shares or options and with 50% CGT discount.

   The Start-up ESOP plans are restricted to businesses that meet all of the following conditions, however:

   - Not listed on public exchange.
   - Aggregated turnover less than $50m. Less than 10 years old.
   - Australian resident taxpayer.
   - Shares must be offered to 75% of employees with more than 3 years' service.

   In addition, employees must also meet the following criteria:

   - Must collectively own less than 10% of shares (and voting rights).
   - Must be employed by holding company or subsidiary or subsidiary.
   - May only receive a 15% or lower discount on shares.
   - Must hold shares for at least 3 years.

2. **Premium Priced Option Plans**

   The Premium Priced Option ESOP model uses options instead of shares and relies upon employees to work with the business owner(s) to build equity value. These plans are a simple and easy to manage model and sit outside the Employee Share Schemes (ESS) tax regime.

   - The company issues options over shares to employees.
   - The options must be issued at a significant premium to the market value of the share (therefore NIL value at time of issue).
   - The employee is taxed on capital account – CGT at marginal tax rates.

3. **Phantom Share Plans**

Whilst these are not technically equity plans or an ESOP, they are designed to provide similar benefits and features of an ESOP, normally in cases where issuing equity is not possible, either due to the ownership structure (such as a family discretionary trust) or where issuing equity might have adverse consequences (i.e. pre-CGT assets).

The plan is simply an agreement between the business owner/s and employee/s to pay a cash bonus equivalent to the increased equity value of the business, either at a certain date or upon a trigger event (usually sale of the business).

This type of payment is normally treated as a cash bonus and so employees must pay tax at marginal rates and also requires the company to have the cash available to make the payout.

Importantly, this payment may also trigger on-costs such as SGC, workers' compensation, payroll tax etc.

4. **Deferred Tax Plans**

As part of the recent changes to the laws affecting Employee Share Plans, the ability to introduce a tax-deferred plan was introduced and has become popular amongst SME business owners.

Deferred taxation means that the employee is taxed on the value of a share or right they acquire under an ESS (ESS interest) at the 'deferred taxing point' (on the market value at that time) rather than at the time they acquire the ESS interest.

Under the current ESS rules, deferred taxation automatically applies to a qualifying ESS interest if either:

- there is a 'real risk of forfeiture' of the ESS interest under the scheme; or
- the scheme is a qualifying salary sacrifice arrangement.

Deferred tax WILL NOT apply if the employee holds a beneficial interest in more than 10% of the issued capital or 10% of the voting rights.

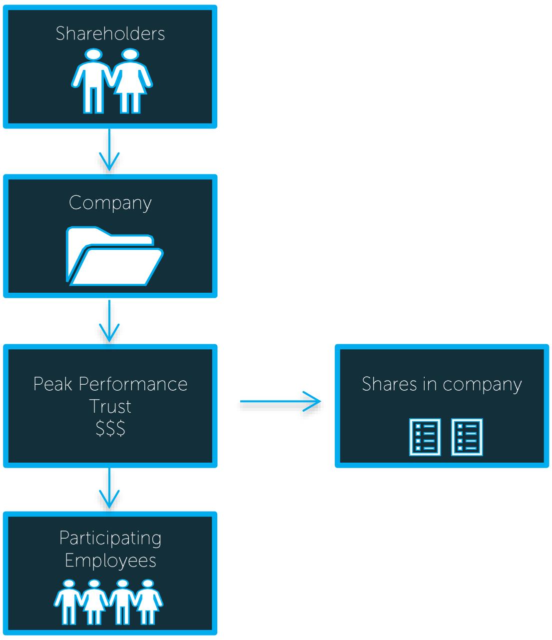
Taxing point only arises when the right is exercised and:

- there is no real risk that, under the conditions of the scheme, that the employee will forfeit or lose the share acquired on exercise (other than by disposing of it);
- and no genuine restrictions under the scheme on disposal of the share.

For all ESS interests, the maximum deferral period under s 83A-120(6) will be 15 years after acquisition of the ESS interest.

## 5. Peak Performance Trust

A Peak Performance Trust or PPT is an employer-created ESOP trust into which contributions are made on behalf of, and for the benefit of, the company's employees. The company commits to investing an amount of money into the trust on a regular basis, contingent upon participating employees achieving predetermined performance outcomes (often profitability targets). As the profits increase, so too does the contribution to the ESOP and the ability to purchase equity on the employer entity.




The benefits of participating in a PPT for both the employer and employee can be considerable. This, unlike any other type of employee incentive tool, truly ties the employee's financial and lifestyle goals to the performance of the company. It is the ultimate 'golden handcuff' for your high-performing staff.

**The Peak Performance Trust:**

- Is affordable for the business;
- Encourages ongoing profit improvement through rewards linked to performance; Is tax effective for both the business and participating employees;
- Reflects the values and culture of the business; Supports employee development;
- Rewards employees who make a substantial contribution to the business; Reflects different individual motivations;
- Does not result in additional administrative work; Is easily understood, controlled and managed; Is appropriate for both the long and short term;
- Complies with all current and likely Australian taxation and legal requirements; Assists in funding succession planning and new business opportunities;
- Helps to influence company culture;
- Gives the company a competitive advantage in recruiting, motivating and retaining high performance staff;
- Assists employees to achieve their financial and lifestyle goals

### How the PPT works

1. The Employer will invite key employees to participate in the PPT. Qualification is usually related to years of employment.

2. A net profit benchmark and a percentage of profits above this benchmark to be shared to the PPT is calculated. For example, the Employer could pay 25% of the net profits generated by the Employer over $500,000. If the Employer's net profits for the year are $600,000, then 25% of $100,000 (i.e. $25,000) will be contributed to the PPT.

3. The Trustee will use this contribution to allow employees to invest in shares in the Employer.

4. Because the PPT has a share in the Employer, and Employees have a unit in the PPT, increased profits will result in an increased value of each employee's indirect share in the Employer. Furthermore, because this is the only type of investment allowed under the deed, the equity value of the trust will always match the equity value of the Employer.

5. Dividends will also be paid annually to employees in proportion to the units held.

6. The only members allowed under the plan rules are employees – so if someone leaves they are automatically excluded and their units redeemed.

7. Qualifying periods are normally set up to govern the "disqualifying discount" – the amount that an employee is "penalised" if they "leave early."

### Case Study – 'ABC Financial Planning Pty Ltd' – PPT for Succession

In the case of this client, the investment strategy for the PPT is simple. It will only ever purchase direct shares in the business, thereby giving participating employees an indirect ownership of the business's equity. Its staff receive dividends and a bonus reward based on the profit performance of the practice. If the practice was to ever be sold, the PPT would benefit from the capital sale, and indirectly, the employees would receive part of that capital gain.

Based on this simple strategy, the value of the PPT automatically replicates any change in the value of the business, therefore employees directly benefit (or otherwise) from any change in value which is largely driven by profit performance and is something that the employees can directly influence. Over time the employees can either purchase a majority stake or 100 % of the business, providing a viable succession solution with predetermined valuation, funding and timing mechanisms.

# Client Testimonials

## C-MAC Industries (Aust.)

Winner, 2012 ESOP of the Year Award

**Australian Employee Ownership Association**

The engagement of employees as owners has already seen an 18% hike in productivity at the plant.

“People are now saying ‘us’ instead of ‘me’ and asking, ‘what do you want us to do?’. Job security is a key motivator at C-MAC and we do not want to lose employees with skills. There are now charts in the lunch room so everyone can see how the business is doing. The change has been truly unbelievable for all staff."

- Steve Grylak
Manufacturing Manager, C-MAC Industries (Aust.)

## LJ Hooker Commercial Central Coast

Winner 2010 ESOP of the Year Award

**Australian Employee Ownership Association**

“Both financial services and property management referrals from employees participating in this scheme increased at a higher level than before. I put this down to their seeing value in contributing to the company’s bottom line because they will share in the profit.”

- Wayne Dowling
Licencee, LJ Hooker Commercial Central Coast

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