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Frequently Asked Questions (FAQs) on Employee Share Ownership Plans (ESOPs)

By SME Business Owners

1. **Will implementing a share plan mean I need to hand over control of my business?**

   A: NO. ESOPs are not designed to transfer control (until you are ready), they are designed to transition equity to your employees to better align your interests with theirs. In most cases we use a corporate trustee for the ESOP and the directors of the corporate trustee (which manages the ESOP) are the same as the main trading entity.

2. **Do my employees expect to pay to join?**

   A: In most cases we can design the Plan so the employees can contribute, but we normally recommend this is not compulsory – otherwise you might preclude good employees who simply can't afford to write out a cheque to participate.

3. **Who pays for the admin costs?**

   A: The PPT pays all costs to administer the ESOP after set-up, which is normally paid by the employer/trading entity. Admin is done centrally by Succession Plus. Whilst the admin is not rocket science, it is very important it is done correctly. We have had one client who suffered a payroll tax audit because the admin was managed by their accountant incorrectly. The typical ESOP costs about $5,000 p.a. to run including bank, admin and accounting fees. It needs to lodge a tax return. Our admin fee includes an annual valuation, which is also required by law.

4. **How do I account for the contributions - expense vs capital?**

   A: The contribution to the PPT are a deductible expense to the company (under 8-1) as they are directly related to employees and should be accounted for separately in the P &L as "ESOP contribution."

5. **How does this affect the normal laws regarding employment/HR?**

   A: The introduction of an ESOP does not change the employment relationship and all of the normal HR laws apply to employees who are members of an ESOP.

6. **Are employees equal or different in ownership levels?**

   A: Employees can be equal, and we have several clients who have done exactly that. More commonly, employees are allocated differing amounts of equity based on salary (seniority), years of service and a performance score or some combination of these factors. It should not be discretionary.

7. **How much equity do I need to sell-down?**

   A: There are no hard and fast rules (and no limits imposed by the taxation law governing ESOPs). We have implemented plans with as little as 10% of shares held by the ESOP and some where the ESOP is gradually buying the whole business (100 %).

   B: The amount you sell needs to be enough to be of value to employees and provide a reasonable stake in the business.

8. **When I sell, do I pay Capital Gains Tax?**

   A: YES. Your sale of shares is a taxable event for CGT, but you will still be eligible for all of the Small Business CGT concessions in the same way as if you sold the business externally.

9. **How do buyers view a business with an ESOP?**

   A: In most cases, this is a strong advantage. In many businesses the key risk from a buyer's point of view is the risk of employees leaving immediately after a sale. Whilst the ESOP cannot stop this, it can certainly reduce the risk by locking employees in with an equity stake. Many plans which are introduced in the lead up to sale include a stay bonus – an extra contribution made to the ESOP if for example, employees stay for 24 months after the sale. In some cases, the buyer will have an ESOP already and simply roll your employees into their plan, many will just continue the existing plan, while in some cases, the buyer may choose to pay out the plan.

10. **What happens if the company makes a loss?**

    A: In the year that the company makes a loss, there are 3 implications - firstly, no contribution will be made, and no further units will be issued in that year, secondly, no dividends are likely to be paid or at least dividends will be reduced, and finally, the valuation of the business (and the ESOP) will decrease.

11. **Can we loan funds to speed up the ESOP?**

    A: Yes, this then makes the ESOP a leveraged ESOP, a very popular vehicle in the US. The employer (or founder) could lend $$ to the PPT to accelerate the purchase. A commercial loan agreement would be needed, interest could be charged, and security taken over the shares purchased using the loan funds. In addition, priority over dividends so that they are used to repay the debt before being distributed to unitholders.

By Employees

1. **What is my risk? What if the company owes money?**

   A: Employees who are members of an employee share plan are protected from any of the liabilities of the employer company and would not be liable for any debts or monies owed. Nor are they required to contribute to any losses incurred by the company.

2. **Can I own the shares in a family trust or my self-managed super fund?**

   A: The PPT allows you to own shares thru an "associate". This could be a family trust (and this is probably a good idea for asset protection) and has some tax benefits as well. We would not normally recommend that employees use an SMSF as the rules around investments are quite strict and a breach of the SIS Act has quite serious consequences.

3. **Does being a member of an employee share plan affect the terms of my employment?**

   A: NO. The share plan rules and qualifying conditions etc relate only to the employee share plan and does not have any effect on the laws which govern your employment including any enterprise bargaining agreement, award or other arrangement.

4. **If the share plan earns dividends from my employer, do these come to me and if so, do I pay tax on them?**

   A: YES. In all of the various structures the employee share plan would normally act as a “flow-through” device and in the case of the truss structure that is commonly used, any given or distributions we see need to be passed through to the individual employees and at that point they would be taxed as part of the employees individual income at marginal tax rates (in many cases dividends would include franking credits and these also are through to the employee).

5. **What happens if I leave the company?**

   A: Except in very specific and unusual circumstances leaving employment would be disqualifying admit and in most of the plans this simply would mean that you are no longer able to the shares or options as you are no longer an employee. In many cases disqualifying events are also accompanied by disqualifying discount and so the value of your shares or options may be reduced, especially if you “leave early.”

6. **Am I now a director of the company or entitled to a seat on the board?**

   A: NO. The employee share plan does not include any right to become a director of the company and in fact most employees do not want to become directors as this may well make them liable other areas. Typically, when a share plan becomes a majority owner in the company, then the sheer plan may have the right to elect an employee to join the board of directors. This though is a matter for agreement between the employees and the current directors/founders of the company.

7. **What information will I receive on the performance of the company?**

   A: Employee share clan members will always receive an annual statement which shows the number of units they hold and the underlying value of the shares in the company. The plan administrators will need to complete an annual valuation of the business as part of this process and that will always include a review of financial statements. Most employers provide a summarised version of this information to ESOP members.

8. **What happens if the company is sold?**

   A: In the event that the company is sold externally there are two possibilities:

   i. Members of the employee share plan are “forced” to sell at the same time as the founders and would therefore be paid out the value of their shares at the time of the sale.

   ii. The buyer decides to keep the employee share plan in place and continues to make contributions etc. in the same way that the original owners did.