GRG Remuneration Insight 130

Succession Planning

Authors: Nida Khoury, James Bourchier & Denis Godfrey

INTRODUCTION

Succession planning is a key issue that needs to be addressed by any responsible business, and especially private companies owned by an individual or group of individuals who work in the business. In these cases, the term succession planning usually refers to an orderly sale of ownership of the business to people who work in it; especially when a trade sale or initial public offering (IPO) is not an available or desired sale alternative.

An often used approach is for senior employees to borrow money from a financial institution to fund the purchasing of equity from the current owners. However, senior employees may have limited capacity to borrow and service the loan. Thus, such arrangements often involve the company and/or the current owner guaranteeing the loan. Hardly a clear exit.

Fortunately, the Government has introduced legislation and regulations that support succession implementation by transferring equity from existing owners to employees over time. This GRG Remuneration Insight provides an overview of these provisions.

LEGISLATIVE SUPPORTING PROVISIONS

There are three main provisions supporting a transfer of equity from existing business owners to the targets for succession, being:

a) The employee share scheme (ESS) taxing provisions which enable tax on equity to be deferred for a significant period,

b) Disclosure relief under s708 of the Corporations Act, and

c) ASIC Class Order 14/1001 which provides relief from various Corporations Act requirements such as a prospectus/offer information statement (OIS)/product disclosure statement (PDS), financial advice, dealing restrictions, hawking etc.

While these provisions are supportive, they also contain limitations that must be complied with to qualify and ensure a desirable outcome for all stakeholders.

COMPANY MUST OWN THE BUSINESS

There are several forms of private business ownership used in Australia, which include sole trader, partnership, trust, and 'company'. While there may be valid reasons for choosing an ownership structure that is not a 'company' it is essential for a business to be owned by a company for the supporting legislation to be accessed. Further, to qualify for tax deferral under the ESS taxing provisions it is necessary that the shares, options or rights used to facilitate the transition of ownership, be in respect of ordinary fully paid shares in the company.

From a practical point of view the number of issued shares needs to be sufficient so that the market value of each share is in the tens of dollars or less rather than hundreds of dollars. This is because ESS taxing provisions do not apply when part of a share is acquired, therefore rounding to the nearest whole must result in a negligible difference in value. Small percentages of ownership are best dealt with when the share price is low as it allows smaller values of shares to be acquired.

OWNERSHIP COMMITMENT

Unlike shares in ASX listed companies there is no 'liquid market' for shares in unlisted companies. This leads to shareholders in private companies needing to accept that their investment in the company will be a long term investment as a buyer for their shares may not be available (noting that lack of a market for the shares is most likely a reason for the succession plan needing to be introduced) and shareholder agreements may limit sale flexibility anyway.

DISPOSAL OF SHARES

If tax deferral applies to the shares acquired by employees, then the latest point in time when tax will be assessed is the earlier of:

a) Cessation of employment, and

b) Elapse of 15 years from the initial acquisition of the share, option or right that gave rise to or was intended to give rise to the acquisition of a share.

To ensure that employees are not put into a difficult financial position of having to fund a tax payment without being able to sell the shares that gave rise to the tax liability it is essential that a buyer be available for the shares or at least half of the shares (with a top tax rate of 47% a sale of 50% of the shares will produce sufficient cash to cover the tax liability).

If the company is private, it would be usual, following a cessation of employment, for there to be a requirement for the former employee to cease ownership so that ownership remains limited to ongoing employees. Retention of shares by former employees in a public company (more than 50 non-employee shareholders) may be acceptable.

If sale of shares by former employees is mandatory, then arrangements need to be made for there to be a buyer of the shares. Such buyers may include:

a) The company under a buy-back arrangement,

b) Other shareholders, or

c) The trustee of an employee share trust (EST) – the EST must satisfy the "sole activities" test. "**Sole activities**" of an **EST** broadly include obtaining shares or rights in a company and ensuring that the shares or rights are provided under an ESS to employees of that company or subsidiary thereof. **Activities** that are 'merely incidental' to these **activities** are also permissible.

When an ongoing program of employees acquiring equity in a company is in operation, alternatives a) and c) above are most likely to be suitable.

s708 OF THE CORPORATIONS ACT

The Corporations Act in s708 provides disclosure relief (no prospectus, OIS or PDS) in relation to the issue of securities in relation to:

a) Small scale offerings (<$2 million raised from no more than 20 persons in any 12-month period) (s708(1)),

b) Sophisticated Investors (transaction for more than $500,000 or with individuals with earnings of more than $250,000 in each of the two prior financial years, or having assets of more than $2 million, as certified by a qualified accountant) (s708 (8)),

c) Offers made through the holder of an Australian Financial Services Licence (AFSL) and the satisfaction of certain conditions (s708(10)), and

d) Senior managers (which covers directors and employees) involved in the overall management of the company (s708(12)).

Of these exceptions d) above will generally be most relevant for the top executive team who are, in effect, partners in the operation of the company's business and most likely to be the targets for ownership succession.

However, for other employees a) and c) may be relevant alternatives.

ASIC CLASS ORDER 14/1001

Under the Class Order that applies to the issuing of equity by unlisted companies, up to $5,000 of equity may be offered to an individual in any 12-month period. While this is substantially less than may be offered under s708 (uncapped), it nevertheless provides an opportunity for employees to become part owners of the companies for which they work. However, there are additional limitations including:

1. Loans may not be used in relation to equity acquisitions in reliance upon this Class Order,
2. Contributions plans (which includes salary sacrifice arrangements) may not be used in relation to equity acquisitions in reliance upon this Class Order, and
3. No more than 20% of issued shares may be granted in reliance upon this Class Order, ASIC Class Order 03/184 and individual ASIC instruments over a rolling 3-year period.

Because of these limits, this Class Order will generally be more relevant to general employee equity acquisitions, while for the senior manager exemption in s708(12) will be more relevant for directors and other senior executives. Both provisions may be relied upon in the same year and should be seen as complementing each other.

PURCHASING OR GIFTING

The current owners of a private company are usually the founders who would have invested their time, skills and financial resources heavily to build the busines to a level of success that is likely to be sustainable and contain significant opportunities for growth in the future. For these founders the business asset often represents a significant financial asset, and it is not unreasonable that they receive reasonable compensation for transferring ownership of that asset to employees.

Employees would have received reasonable remuneration during their tenure and the business owners would have no financial obligation to provide free shares to employees. Accordingly, it would be unreasonable for employees to expect to be gifted free shares. Having made this point it sometimes occurs that owners feel that they would like to share the realisation of the value of the business being sold with employees, particularly those who have given long and loyal service and have contributed to the growth and success of the company. Such actions may occur as part of a succession plan but would be unlikely to form the foundation of such a plan. The foundation needs to be effectively a purchase of equity by employees at fair market value.

PURCHASING APPROACHES

There are three main opportunities for employees to acquire equity on a tax deferred basis:

1. Re-direction of part of Fixed Pay on a pre-tax basis to funding equity acquisitions. This approach is simple to implement for senior executives as there is considerable flexibility in being able to structure Fixed Remuneration components and grants are made under s708 of the Corporations Act. For other employees this approach is more challenging to implement. For employees who are paid award rates there is no scope to use this approach as it requires a reduction in Fixed Pay as part of their employment terms ("salary sacrifice" must be avoided for regulatory reasons) or the provision of an increase in Fixed Pay to be delivered in, say, share rights. GRG's understanding is that salary levels cannot be reduced below the relevant award rates so there is no scope to apply this approach. Also, ASIC Class Order 14/1001 cannot be relied upon when the arrangement is structured as a contribution plan.

2. Delivery of part or all of annual bonuses on a pre-tax basis in, say, Share Rights. This is available for all levels of employees provided it is not structured as a salary sacrifice arrangement for grants relying upon Class Order 14/1001.
3. Delivery of long-term variable remuneration for roles that warrant such a component as part of their total remuneration packages. Such plans typically involve annual grants of Share Rights which vest based on performance over a 3-year measurement period.

SOURCES OF SHARES

It is standard practice in Australia under equity remuneration plans for shares to be acquired and held, on an "allocated" basis for the benefit of employees by the trustee of an EST. When vested Share Rights are exercised the company contributes the value of the shares to the EST and the trustee applies the funds to acquire shares via subscription to a new issue or a purchase from an existing shareholder at fair market value. The contributions should qualify as a tax deduction for the company. Fair market value may be calculated under agreement using a formula such as a multiple of EBIT, or via an annual independent professional valuation, which often involves a substantial expense.

When companies pay dividends it is important that the Share Rights be exercised as soon as possible so that employees become entitled to participate in dividend distributions.

DISPOSAL RESTRICTIONS

So as to qualify for tax deferral it is necessary to use Share Rights with disposal restrictions rather than shares. In addition to defer the taxing point beyond the time when Share Rights are exercised it is necessary for disposal restrictions to apply to the shares acquired on exercise of the Share Rights. Such disposal restrictions need to apply until the earlier of cessation of employment with the company and elapse of 15 years from the date of grant of the Share Rights. Such restrictions are consistent with the ownership commitment discussed earlier.

10% LIMIT

Tax deferral under the ESS taxing provisions is not available to employees who own or control the voting of more than 10% of issued shares. As a consequence, the ESS tax deferral provisions should and may be used up until an employee has acquired 10% of issued shares. Thus, if 10 or more senior employees are to jointly become the new owners of a company under a properly structured succession plan the ESS tax deferral provisions should be sufficient to facilitate the ownership transition without the need to resort to other less tax effective approaches.

CONCLUSION

By combining the methods outlined in this Insight, many unlisted companies can avoid expensive external financing options to complete a successful ownership transition and succession plan.