



cutting through complexity

ADVISORY

# Employee share schemes

An introductory guide

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# CREATING A PLATFORM FOR BETTER PERFORMANCE

# Following legislation introduced in 2014,

the time is ripe for private companies in New Zealand to consider offering their employees an ownership stake in their business.

Employee share schemes have been used for many years as a tool to reward, retain and attract talent by offering employees a stake in the companies they work for. In New Zealand, employee share schemes have traditionally been the domain of large corporate, due to substantive compliance costs and the complexity of relevant securities law. However, the Financial Markets Conduct Act 2013, introduced in 2014, has made share schemes easier to set up and implement, as well as more affordable, for private companies.

In this introductory guide, we explore why companies establish share schemes, what to think about when choosing a scheme, and recent developments in the tax environment.

## THE BENEFITS OF HAVING AN EMPLOYEE SHARE SCHEME

A share scheme can create a platform to enhance performance as it aligns an employee's interests with those of the business shareholders. Employee share ownership is an effective way to achieve a number of important business objectives, including:



### **Attracting, motivating and retaining key staff.**

It is widely acknowledged that employee ownership can generate greater employee buy-in, incentivisation, and retention.



### **Focusing key staff on attaining the long-term objectives of the business.**

Key employees are motivated to build sustainable value, rather than fulfil short-term personal goals, when they have a vested interest in the company's ultimate success.



### **Providing a cash-free source of remuneration.**

Share ownership is a way to reward performance, or increase remuneration of employees, without impacting on the company's working capital or cash-flow position.



### **Providing further options in succession planning.**

Employee share schemes can provide a vehicle for transitioning company ownership in a managed way, and to a buyer you can entrust with the future of your business. For instance, where the right candidate exists, share schemes can provide an avenue for an eventual Management Buy Out (MBO).

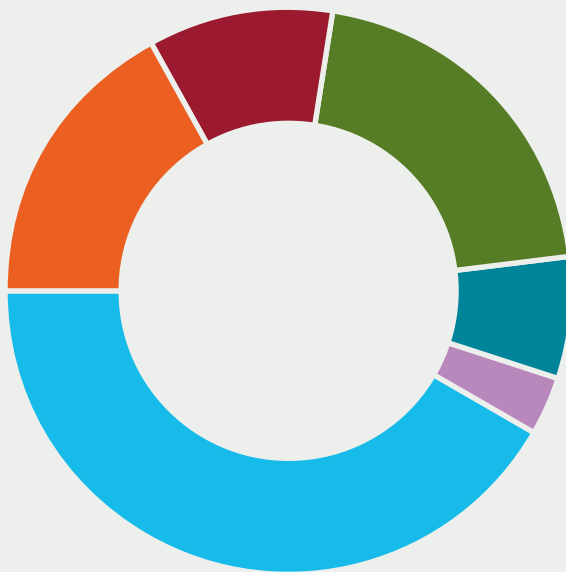
Whether or not a share scheme is appropriate for a business will depend on a number of factors. This includes the economic and industry landscape (e.g. how competitive the talent hunt is); as well as where the business sits in its life cycle (e.g. if the founders are looking to exit, or are seeking the capacity to undertake a significant growth plan).

# DIFFERENT OPTIONS FOR STRUCTURING YOUR SHARE SCHEME

When it comes to choosing the structure of their new employee share scheme, companies have a number of options. The most popular structure for privately-held companies is an employee share loan, and we explore this in more detail on page 4. But first, we look at the types of schemes typically used by public companies, and compare these to private companies.

## MOST NZX COMPANIES HAVE AN EMPLOYEE SHARE SCHEME

Of the listed companies on the NZX50, 78% employ at least one form of employee share scheme (with 33% of these employing two or more types). While these companies use a broad range of share scheme approaches, performance share rights are the most common (41% of companies with an employee share scheme), followed by employee share loan schemes (21%).



## TYPES OF SHARE SCHEMES USED BY NZX50 COMPANIES

- Options **17.2%**
- Phantom share scheme **10.3%**
- Employee share loans **20.7%**
- Partly paid shares **6.9%**
- Different share classes **3.5%**
- Performance share rights/restricted stock units **41.4%**

**Source:** Most recent company financials as at March 2015.

**Note:** Percentages reflect the proportion of employee share schemes employed by NZX50 companies that fall into each category of scheme. Companies on the NZX often employ more than one type of scheme.



# A SUMMARY OF THE DIFFERENT TYPES OF SCHEMES

There is a wide range of techniques available to offer employees share-based incentives. Companies will choose a particular scheme depending on a number of factors, including the tax position. The table below provides a summary of the most common methods seen in practice and compares the approach of public versus private companies.

	PUBLIC COMPANIES					
	PRIVATE COMPANIES					
	Employee share loans	Partly paid shares	Different share classes	Performance rights/restricted stock units	Options	Phantom share schemes
<b>Description</b>	Company provides a loan to employees to buy shares at market value. Loan may or may not be interest bearing	Company grants the employee partly paid shares. The balance outstanding can be called by the company at a later date	Company grants the employee shares with different rights (e.g. class B shares) at market value.	Company grants the employee shares once specified performance hurdles have been met. Consideration can be nil or negligible	Company grants employee options to buy shares at a future date at a specified or benchmarked value	Company provides the employee with a cash payment which is referenced to the company's share price
<b>Valuation</b>	Value underlying shares at grant date	Value underlying shares at grant date	Value underlying shares at grant date	Value share rights at grant date together with underlying shares if not publicly listed	Value options at grant date together with underlying shares if not publicly listed	Value phantom options at grant date together with underlying shares if not publicly listed
<b>Complexity</b>	Low, unless company has issued put/call options on the shares	Low, unless company has issued put/call options on the shares	Moderate	Dependent on terms	Moderate to high	Moderate to high
<b>Cost</b>	Low	Low	Moderate	Moderate	High	Low
<b>Life of scheme/refreshability</b>	Permanent/Limited opportunity to refresh once issued which may be mitigated if company issues put/call options on the shares	Permanent/Limited opportunity to refresh once issued which may be mitigated if company issues put/call options on the shares	Permanent/Limited opportunity to refresh once issued which may be mitigated if company issues put/call options on the shares	Rights usually have an expiration date	Options usually have a finite life	Phantom share schemes usually have a finite life
<b>Tax impact – company</b>	Low, no FBT on loan if properly structured	Low or nil	Low or nil depending on instrument	Low or nil	Low or nil	Low or nil. PAYE deductions are required
<b>Tax impact – employee</b>	Refer to page 7 for tax considerations	Refer to page 7 for tax considerations	Refer to page 7 for tax considerations	Refer to page 7 for tax considerations	Refer to page 7 for tax considerations	Refer to page 7 for tax considerations

# PRIVATE COMPANIES FAVOUR EMPLOYEE SHARE LOANS

Employee share loans are commonly used by privately-held companies as they are simple to implement and generally have no or simple vesting conditions. Another benefit of the employee share loan approach is that it provides financial assistance to employees that might otherwise not have the funds to buy into the company. Often, employees repay the loan principal out of dividends paid on the shares, bonuses, or from the future share sale proceeds in the event of a sale.

Some control over the employee is possible, usually through a set of Scheme Rules. These may restrict the ability of the employee to sell the shares whilst they are employed, or provide pre-emptive rights with punitive conditions in the event of an early exit from the company – sometimes referred to as ‘bad leaver’ provisions. In the event that an employee leaves, many schemes allow shares to be sold back to the company for the same amount as the loan (an effective put option). Vesting conditions can also be included that can provide for the attainment of certain performance hurdles, which if not achieved, can enable the company to call back the shares. Note that the inclusion of these terms has value implications.

## OTHER POSSIBLE SCHEME TYPES

### PARTLY PAID SHARES

Partly paid share schemes involve the company issuing a share to an employee at market value, but only requiring a partial payment on the share. The outstanding balance on the share is generally payable once certain performance criteria have been achieved and/or the share price attains a certain value. In the event that the employee leaves and does not meet a performance hurdle, the employee is provided with an option to sell the shares at the issue price back to the company.

These schemes used to be popular because of the small capital outlay for employees, and the riskless position achieved by employees by virtue of the option to sell the shares back to the company. However, these schemes have fallen out of favour in recent times due to uncertainty over the tax status of such schemes.

### DIFFERENT SHARE CLASSES

Under this approach, the company issues employees with shares that have different (and usually less) rights than the shares held by ordinary shareholders. For example, employees may have no voting or dividend rights. Often the shares are issued at a nominal value to reflect the fact they do not yet have any beneficial right attached to them. The employee may then make payments over the course of the restrictive period, with the shares converting to ordinary shares once they are fully paid or certain vesting conditions are met.

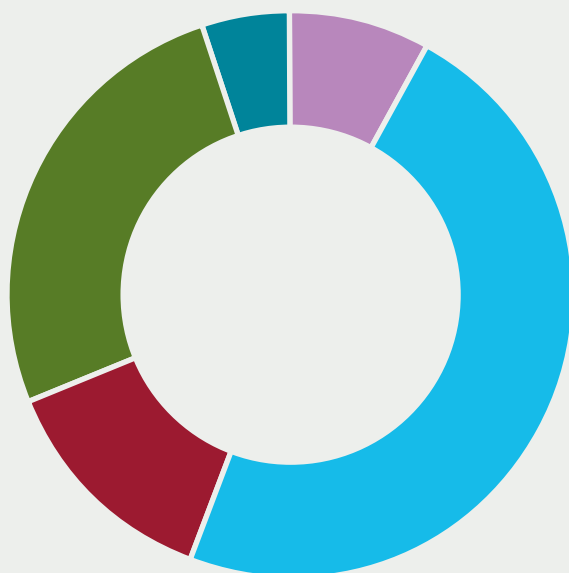
The appeal of this approach is that key company insiders (e.g. the owners) can maintain greater control over the company through differential voting rights. However, these schemes have been subject to increased scrutiny from Inland Revenue. In particular, Inland Revenue has expressed concerns where schemes such as this accelerate the taxing point, leaving the employee bearing no economic cost.

### OPTIONS AND SHARE RIGHTS

Option and performance share rights techniques typically require the company to have a solid reference point for the share price, which private companies do not have. For this reason, they are seldom used by private companies.

# CONSIDERATIONS AROUND THE VESTING PERIOD

One of the key motivators for introducing a share scheme is to retain key employees within the business. For this reason, companies typically seek to tie employees to the business through vesting periods. Vesting periods require the employee to remain employed by the business in order to receive the shares or the rights to invest in shares. The most common vesting period for NZX50 listed companies is three years.



## VESTING PERIODS OF NZX50 COMPANY SHARE SCHEMES

- 3 years **48%**
- > 3 years **13%**
- Mix **26%**
- N/A **5%**
- < 3 years **8%**

**Source:** Most recent company financials as at March 2015.

**Note:** Percentages reflect the proportion of NZX50 companies with an employee share scheme that adopts a given vesting period.

## PRIVATE COMPANY IMPLICATIONS

In designing a share scheme for employees, private companies should also consider using vesting periods to encourage loyalty to the company. The appropriate vesting period length will depend on a number of factors, including any liquidity event (e.g. IPO), anticipated retirement, and alignment with significant investment milestones.

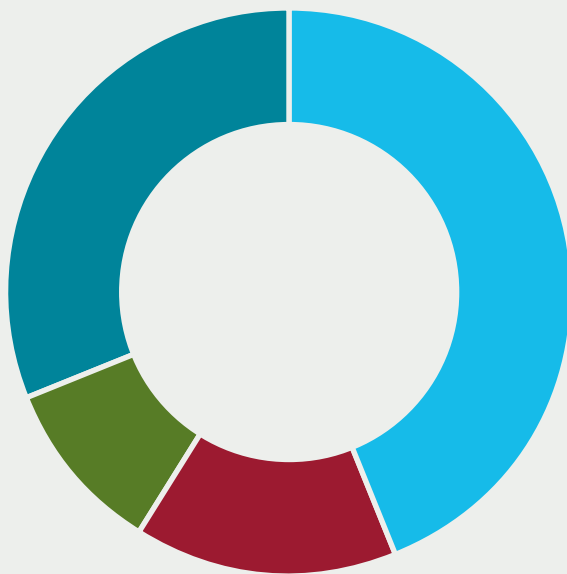
In addition, consideration should be given as to what restrictions should be placed on the transfer of employee ownership stakes. Existing shareholders in private companies generally want to retain control over the management team, as well as protect the company from outsiders taking an ownership stake. There are a number of ways to achieve this.

For instance, employees might be restricted with regard to whom they can transfer their ownership stakes to, or be required to sell back their stake to the company under particular circumstances, such as cessation of employment.

There are other considerations from the employee's perspective. Because the shares of private companies are inherently illiquid, employees may seek assurances that they will be able to ultimately realise any gains as shareholders. For instance, employees may seek a provision that the company will purchase back their shares should their employment cease, or if a liquidity event doesn't occur within an acceptable period.

# MEASURING PERFORMANCE IS KEY

Appropriately rewarding employees for their performance is possibly the most challenging aspect of share schemes. The complexity of such schemes has generally increased over the past decade, with many involving multiple performance hurdles for the employee to receive a payout under the scheme. In the worst case, employees can no longer determine whether they are meeting the hurdles set for them. In our view, the key challenge is designing a scheme that gets the balance right – that is, one that sets the right incentives, without being too complex.



The cost of implementing schemes with complex performance measurement should also be considered. Too often schemes are designed with little regard for the implementation costs associated with measuring performance and valuing the consideration for financial reporting purposes. Sometimes companies have abandoned initial designs once the full cost of administering the scheme has been determined.

Many listed companies use total shareholder return (TSR) as the basis for the measurement of performance. This measure evaluates shareholder returns from both the capital appreciation in the share price and dividends paid.

## PERFORMANCE METRICS OF NZX50 COMPANY SHARE SCHEMES

- TSR **44%**
- TSR and EPS **15%**
- TSR and other **10%**
- Other/not specified **31%**

**Source:** Most recent company financials as at March 2015.

**Note:** Percentages reflect the proportion of NZX50 companies with an employee share scheme that employ each type of performance metric.

## PRIVATE COMPANY IMPLICATIONS

For unlisted companies, the challenge of measuring performance is greater. Performance measures are often tied to accounting measures, such as sales or profit targets, or simply not included at all. One of the difficulties in using accounting measured targets is that they could lead to employees focusing on short-term gain, at the expense of the company's longer-term prospects. For instance, the budget-setting process by which targets are identified might be compromised or proper investment (e.g. R&D) in the firm might be cut back in order to boost profits in the current period by employees seeking to maximise their remuneration package.

For this reason, private companies often commission a periodic valuation of the business to provide a reference point for the measurement of the creation of shareholder wealth. Other alternatives also include employing non-financial performance and/or time-based hurdles. Examples of appropriate non-financial performance hurdles will vary across industries, but could relate to things such as market share gain, brand awareness, or employee satisfaction. Similarly, time-based hurdles could relate to the time served by employees, or the consistent outperformance in some financial measure (as opposed to the outperformance being a one-off event).



# THE TAX REGIME IS TIGHTENING

The tax treatment of an employee share or option scheme depends on the nature and terms of the scheme. The overarching principle however, is for employees to be taxed on any benefit they receive in shares or options as a consequence of the employment arrangement at the time that the interest vests to the employee. Given the wide range of schemes and the differing terms, it is important that tax implications are considered on an individual scheme basis rather than adopting a one-size-fits-all approach.

In simple terms, the taxable benefit is calculated with reference to the market value of the shares awarded or options exercised less any contribution made by the employee. Where a company issues options, the value and timing of the benefit is fixed on the date on which the right or option is exercised.

The taxable benefit to the employee under a share or option scheme is employment income for tax purposes. However, unlike other income of this nature (e.g. salary and wages), the collection and payment of the tax is currently the responsibility of the employee rather than the employer. Depending on value, this can give rise to obligations to file income tax returns and pay provisional tax which will need to be managed by employees.

Inland Revenue has announced an intention to change the way tax is collected in respect of employee share schemes. With effect from 1 April 2017, it is proposed that employers will be able to elect to withhold tax on employee share benefits using the PAYE system. From 1 April 2017, employers will also have a disclosure obligation in respect of employee share scheme benefits provided to employees irrespective of whether or not the PAYE system is used for the payment of tax. Payroll systems will need to be reviewed to ensure that compliance with new rules is possible and employees should be kept aware of their obligations.

## IRD'S RECENT RULING ON CHORUS LIMITED'S SHARE SCHEME

After a period of uncertainty as to the tax situation of many schemes, the IRD recently released a product ruling in relation to Chorus New Zealand's long-term incentive plan for senior executives. This scheme involves the use of employee share loans. The ruling provides a welcome clarification of the tax treatment of these types of schemes, the details of which are in product ruling BR Prd 15/01.

Although the product ruling provides useful guidance, the taxation of share schemes generally is being considered by Government. Accordingly, it's possible that the tax treatment of employee share schemes may change in the near future. Furthermore, the use of certain employee share schemes are under scrutiny by Inland Revenue, as it believes the schemes produce tax outcomes that are contrary to the intention of policymakers. For these reasons, it is important that advice is sought in relation to any new employee share schemes proposed.

# NEXT STEPS

Employee share schemes can be a compelling tool for companies to retain, motivate and reward talent within the business. Establishing a successful scheme requires careful thought and planning, and a long-term view on how the scheme will perform in the good times and bad.

## SOME QUESTIONS TO CONSIDER:

- ❓ What does the Board hope to achieve with the scheme?
- ❓ Who will participate in the scheme?
- ❓ Will this be an effective tool to boost remuneration levels and retain key staff?
- ❓ What would be appropriate performance measures?
- ❓ What are the tax and accounting implications of the scheme?
- ❓ Will the company use a Trust to hold the shares on the employee's behalf? (Trusts are frequently used to minimise the shareholder interaction between the company and potentially a large collection of employees.)
- ❓ Is the scheme sustainable long-term for the company and the shareholders?

### **Employee share schemes can provide a platform to achieve various business goals.**

For them to be successful, you need to adopt the right kind and structure of scheme for your business. KPMG can help you with the following services:

- » Share scheme consultation
- » Structuring and implementation advice
- » Scheme valuation
- » Tax and accounting advice

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