Employee share ownership in privatized companies:

Assessing the potential for ESOPs in Mongolia

March 2006
Ulaanbaatar, Mongolia

Project:	Mongolia Economic Policy Reform and Competitiveness Project (EPRC)
Report Title:	***Employee Share Ownership in Privatized Companies: Assessing the Potential for ESOPs in Mongolia***
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Contract No.	438-C-00-03-00021-00
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ABBREVIATIONS AND ACRONYMS

AESOP	All-Employee Share Ownership Plan
AMT	Alternative Minimum Tax
APSS	Approved Profit Sharing Scheme
CGT	Capital Gains Tax
ESA	Employee Shareholder Association
ESOP	Employee Share Ownership Program
ESOT	Employee Share Ownership Trust
EVCC	Employee Venture Capital Corporation
ISO	Incentive Stock Option
NIC	National Insurance Contribution
NSO	Non-Qualified Stock Option
PAYE	Pay-As-You-Earn
PE	People's Enterprise
SAYE	Save-as-You-Earn
SOE	State-Owned Enterprise

TABLE OF CONTENTS

EXECUTIVE SUMMARY

The use of employee stock ownership plans (ESOPs) and related strategies for providing employees an opportunity to acquire partial ownership in the companies where they work has grown in popularity over the past two decades. This is particularly true in the context of privatization programs in both the developed world and in emerging market economies. Dozens of countries have incorporated some form of employee ownership in privatized enterprises and in many cases have adopted specific legislative and fiscal policies to facilitate the acquisition of stock ownership by employees. This strategy is driven by a variety of complementary goals ranging from building support for privatization efforts, broadening the ownership of productive capital assets, improving corporate performance, and promoting growth oriented economic development policies.

This report describes the rationale for using ESOPs in privatization programs and provides a description of how ESOPs and related approaches to employee ownership work in actual practice. It provides a survey of international best practice in the use of ESOPs, including examples of government incentives used to facilitate the incorporation of ESOPs in privatization transactions and private sector development. The final section includes a discussion of the practical implications of introducing ESOPs in Mongolia.

The practical applications of ESOPs are as varied as the many different legal and social environments in which they have been implemented but several key principles stand out in terms of effective employee ownership programs:

- Policy support is essential. To operate effectively, ESOPs and related stock plans require a clear legal, tax and regulatory environment. In addition, government support for ESOPs through any of a variety of incentives to encourage employee participation in ownership is a prerequisite for encouraging the use of ESOPs in privatization transactions and private companies.
- Access to credit is the essential element needed to facilitate significant employee shareholding since employees lack the ability to purchase any significant amount of shares on their own. A variety of techniques have been developed to provide employees with access to credit, most prominently those associated with ESOPs.
- Encouraging long-term and on-going employee share ownership that is not limited to one-time privatization transactions requires that laws governing employee ownership plans be applicable for private sector companies as well.
- Careful consideration must be given to rules governing the structure and operation of employee stock plans. This is particularly true in regard to issues involving valuation, corporate governance, shareholder rights and access to information.
- Education and training is key both for employees who lack experience as shareholders and for companies unaccustomed to working in a shared ownership environment.

SECTION I: INTRODUCTION

Economic development efforts worldwide increasingly emphasize the importance of reducing the role of the state in the ownership of productive enterprises. Privatization is essentially seen as a process of replacing the single state owner with multiple owners who will be motivated to operate the business more efficiently in response to market signals.

Countries as diverse as Argentina, Chile, China, Egypt, France, Hungary, Ireland, Jamaica, Pakistan, Poland, Russia, Slovenia, South Korea, the United Kingdom, the United States and others have made employee ownership and broad-based ownership a key element of their privatization programs. Specific techniques for utilizing employee ownership vary widely from country to country and the use of employee ownership in international privatization efforts is subject to different social, legal and economic conditions. Indeed, the flexibility of the concept is one of the key attributes of employee ownership. In its simplest terms, however, employee ownership seeks to create incentive reward systems predicated on widespread ownership of productive capital.

Employee ownership is considered to be a market-based mechanism for promoting broader distribution of ownership and participation in the free enterprise system. Historically, capital appreciation in established market economies has outpaced the growth of wages. In a globalized economy, capital ownership enables workers to benefit from long-term capital appreciation rather than relying solely on wages and pension benefits. Wealth acquired through share ownership therefore can help relieve the fiscal pressure on governments to provide enhanced pension, social security or other government-funded benefits.

It is important to emphasize in this context that employee ownership does not necessarily mean ownership exclusively by employees. In fact, experience worldwide shows that, except for rare exceptions or for relatively small companies, most employee ownership plans acquire minority ownership positions. Particularly in the context of privatization of state-owned enterprises, “mixed” privatizations involving outside investors (both individual and institutional), foreign companies, and employees are likely to predominate. Indeed, in many cases it is preferable to ensure that employee ownership is limited to a minority stake in the enterprise to avoid the problem of management entrenchment and insider control that may be antithetical to the introduction of market reforms.[1]

When properly structured, employee ownership plans can have a positive influence on both the privatization of state-owned enterprises as well as the development of broad-based ownership of productive assets. It is critically important, however, to ensure that employee ownership plans are integrated into an overall privatization strategy that is intended to restructure privatized enterprises to prepare them for market competition. To maximize the long-term potential of employee ownership, governments need to consider how best to facilitate employee acquisition of shares in privatized enterprises, how to integrate employee ownership with overall strategies for restructuring and privatizing state-owned enterprises, and how to ensure the effective operation of employee stock plans once the privatization is completed. Ensuring an effective tax, legal and regulatory environment for employee ownership plans in privatization transactions can also help to facilitate the implementation of employee ownership plans by companies in the private sector.

[1] The experience of the Russian privatization program is illustrative in this context. Following the first round of privatizations of medium-size and large enterprises, employees and managers owned an average of two-thirds of the enterprise stock in the majority of companies immediately following privatization. In the absence of shareholder rights and securities law standards, however, most of that ownership was eventually acquired by an elite minority within the enterprise or by well-financed outsiders.

This paper discusses the rationale for why employee ownership has been a key element of the privatization strategy of growing numbers of governments around the world and provides an overview of international best practices with regard to the use of employee ownership plans in privatization programs. It provides a detailed explanation of the structure and applications of employee stock ownership plans (ESOPs) which are typically used to provide ownership benefits to virtually all of a company's employees, and contrasts ESOPs with other methods of transferring stock ownership to employees. After providing examples of incentives various governments have offered to encourage the use of employee ownership plans, the paper concludes by offering suggestions for how ESOPs might be incorporated into privatization programs and private sector development efforts in Mongolia.

SECTION II: RATIONALE FOR THE USE OF ESOPs IN PRIVATIZATION

One of the main attractions of employee ownership is its broad appeal in terms of both macroeconomic policy and corporate reorganization. Policy makers implement employee ownership strategies for a variety of reasons ranging from distributing private ownership broadly throughout the economy, enhancing enterprise performance by giving workers an economic stake in its financial success, improving labor-management relations and promoting notions of economic and social justice. Whereas Marx observed that conflict between owners and workers is built into the capitalist system, the emergence of employee ownership in both the developed world and in emerging market economies represents a new dynamic of free enterprise that emphasizes widespread participation in the ownership of productive property. Establishing widespread capital ownership is therefore seen as a means of strengthening the constituency for free enterprise by giving employees a direct financial stake in the performance of private corporations.

A. Broadening Capital Ownership

Incorporating employee ownership strategies into privatization programs provides governments with an opportunity to broaden participation in the ownership of productive assets beyond the realm of economically privileged nationals or foreign investors. Experience in those developing countries that have followed such a strategy demonstrates that the benefits are maximized when the transfer of shares to employees is accompanied by an effort to develop an ownership culture among the workers by encouraging long-term capital ownership. Over time, employee ownership can help to foster the development of capital markets from the ground up by promoting greater knowledge of share ownership and developing a future source of new shareholders.

B. Addressing Labor Concerns

In many countries privatization programs have been resisted by unions, workers, and consumer groups who feel that privatization requires them to give up job security, subsidized wages and other benefits with little or nothing in exchange. A strategy aimed at making employees a key ownership constituency can save on political, economic, and administrative costs associated with privatization strategies that do not address the legitimate economic concerns of the work force.[2] In that context, employee ownership offers a practical means of jump-starting the privatization process by organizing a clearly defined, knowledgeable shareholder group that has a vested interest in working for the success of the privatized enterprise.

C. Financing Employee Share Acquisition

The use of employee ownership in the privatization process does not necessarily mean giving away state assets to employees without compensation. Indeed, employees are often encouraged to purchase stock in the context of privatization, albeit at discounted prices with deferred repayment terms at subsidized interest rates. But since employees typically have limited or nonexistent investment capital, employee investments in the ownership of state-owned enterprises are more often structured with the use of credit, either from the state, from strategic investors or from third party lenders, backed by the credit of the enterprise itself. Indeed, for an employee ownership strategy to succeed to any significant degree in providing large numbers of workers with the ability to acquire meaningful ownership stakes, providing workers with access to credit in the context of privatization initiatives is essential.

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[2] Jeffrey R. Gates and Jamal Saghir, “Employee Stock Ownership Plans: Objectives, Design Options and International Experience”, CFS Discussion Paper Series #112, The World Bank, 1995.

D. Improving Enterprise Performance

Providing workers with a shared financial interest in the success of the enterprise can provide an incentive to improve productivity. The considerable research on employee ownership and corporate performance indicates that companies that combine significant levels of employee ownership with participatory management techniques show productivity improvements compared to their non-employee owned competitors.[3] Employee ownership can also provide an opportunity to enhance labor-management relations. Conversely, evidence from privatization experience in various countries suggests that rank-and-file employees and their unions may react negatively to ownership changes if they perceive that their economic interests are not taken adequately into account.

E. Employee Ownership and Corporate Governance

Employee ownership does not mean day-to-day control or management of companies by workers, nor does it mean that all important business decisions will be made collectively by a large group of employees. Just as in traditional corporations, boards of directors and management will continue to be responsible for developing long range business planning in employee owned companies, subject to oversight and ultimate control by the company's shareholders. Best practices among employee-owned companies typically include efforts to facilitate more informal, job-related participation programs and more robust communication programs to educate and inform workers about the operational details of the enterprise and how they can be improved. Properly structured employee ownership plans can nevertheless ensure that employees have increased influence through voting rights, access to information, and sufficient representation in formal corporate governance structures. In some cases it may also provide the means for the workers to be collectively represented on the board of directors or management councils of certain enterprises.

F. Promoting Long-Term Ownership

One of the short-comings of some privatization programs that have incorporated employee ownership in privatization transactions has been a failure to facilitate long-term stock ownership by employees. Employees quite rationally regard stock ownership as a means to supplement their incomes and the ability of employees to sell their shares is an essential component of an effective ownership strategy. But a key aspect of using employee ownership as part of a privatization strategy should be to encourage longer term ownership to both provide some short-term stability in the ownership structure of privatized companies and to provide sufficient time for the newly privatized company to create value for its shareholders.

G. Facilitating Employee Ownership in the Private Sector

Finally, creating opportunities for employees to acquire ownership stakes in existing enterprises should also be combined with efforts to create ownership opportunities in existing private companies. Once a privatization transaction is completed the privatized company will by definition be operating in the private sector. The rules governing the operation of employee ownership plans must therefore be integrated with laws and regulations governing private corporations. In addition to ESOPs and similar plans that provide ownership to a majority of a company's employees, company law should facilitate the use of incentive-based stock compensation programs such as stock option plans to help entrepreneurs attract and retain talented

[3] For a summary of the evidence of the impact of employee ownership on corporate performance see http://www.nceo.org/library/corpperf.html published by the National Center for Employee Ownership (USA).

employees by offering equity incentive awards. Rather than limiting employee ownership strategies to one-time privatization transactions, such a strategy holds the promise of promoting stock ownership in new and existing private sector firms.

SECTION III: ESOPs AND RELATED EMPLOYEE STOCK PLANS

As described more fully below, the term “ESOP” is used to describe a particular type of trust-based plan that has specific legal attributes and that is generally intended to hold stock for the benefit of a broad base of a company’s employees. Other stock plans, by contrast, are more typically used to provide incentive compensation to selected employees. In international practice, the term “ESOP” is commonly used to refer to any of a broad range of employee ownership vehicles, including direct purchases, stock options and others. Indeed, many such ESOPs combine various features of employee ownership plans.

A. Direct Share Purchase Strategies

The most common approach to encouraging employee ownership in privatization transactions is to permit employees to purchase shares, typically with some sort of subsidy (either a price discount or deferred payment terms). This approach has the merit of simplicity, is based on a fair market exchange (albeit with a subsidy in most cases), and is premised on employees making the choice to invest their own money rather than being given shares for free, which is often a priority for governments and/or sponsoring companies. One of the problems with limiting employee ownership to what employees can buy with their own money, however, is that employees rarely have sufficient resources for purchasing shares and cannot realistically be expected to acquire any significant ownership through direct purchases.

Another problem with the employee purchase approach is that there will typically be significant disparities in the financial resources available to participating employees. If broad-based ownership is the goal, purchase plans may result in only senior-level employees acquiring any significant amount of shares. In addition, any subsidies provided for employee share purchases are typically limited to the one-time event of the privatization transaction itself. That further limits the ability of any newly-hired employees to acquire shares in the restructured company. Requiring employees to invest their own limited resources also increases the pressure for employees to want to sell their shares for short-term profits.

B. Employee Stock Options

Stock options – which are the right to purchase stock in the future at a pre-established price – offer some marginal improvement to the share purchase strategy. By deferring the time in which employees are obliged to come up with the purchase price, stock options avoid an immediate drain on employees’ personal cash finances. Options also reduce employee risk since they can always choose not to exercise their options if the underlying share value does not increase over the life of the option. And cashless exercise features – in which employees are essentially provided with shares representing only the appreciation in the initial option price – offer additional opportunities for structuring ownership-broadening strategies with stock options.

Options are not, however, actual ownership. In the context of privatization efforts they may be problematic in terms of establishing new ownership patterns and they represent an added level of complexity for both the company and the employees, most of whom will have had little experience with share ownership, much less stock options. Broad-based options may indeed be an attractive means of fostering broad-based employee ownership in new companies or perhaps as a supplement to other employee ownership programs, but are problematic as the primary focus of privatization efforts.

C. Stock Grants

Direct stock grants are commonly used in both privatization programs and in private sector companies with established employee ownership programs. Share grants, which are typically subjected to various types of restrictions, provide employees with taxable income in the form of share ownership without requiring employees to pay for the shares. Such awards can be in the form of performance awards, as a matching grant to employee savings deferrals or as a means of providing employee groups with a targeted percentage of a restructured company's shares. As such, it can be an attractive means of transferring shares to employees with little or no assets.

The problem with share grants is that the government, in the case of state-owned enterprises, receives no income for the transfer of those shares and runs the risk of being accused of wasting state assets. Employees may also value "free" shares less highly absent some means of tying the awards to improved long-term enterprise performance. Share grants can play an important role in privatization exercises – either as a means to provide some initial ownership to a broad range of employees or as a means to induce greater employee participation through matching contributions to stock deferrals or targeted awards for key performers – but they should be used sparingly since they generate no revenue for the selling shareholder.

D. ESOPs and Employee Trusts

The term "ESOP" refers to a plan in which a trust is established for the exclusive benefit of employee participants, and the employees beneficially own the stock held in trust for them. There are many thousands of such plans currently in operation in a number of countries around the world. The essence of the trust vehicle is that there is some restriction on the rights and benefits as compared to the rights that are enjoyed by individuals who own stock directly in their own name as minority shareholders. Along with these restrictions come certain benefits (such as deferred taxation and regulatory protections). In countries that do not have the proper legal structure for trust law, one approach has been to establish employee associations or other special purpose vehicles which parallel the trust structure to hold shares on behalf of employees.

ESOP trusts often acquire shares as a result of a tax-deductible contribution from the sponsoring corporation as an employee benefit. It is simply a means whereby the company chooses to share stock with employees as a long-term benefit or retirement award. The shares contributed to the ESOP trust are allocated to individual employee accounts according to a pre-established formula (typically either equal distribution, as an equal percentage of salary, or weighted to employees with greater seniority) and held in the trust for a specified period of time.

Trust-based models such as ESOPs offer several practical advantages. They aggregate ownership so that employees as a group can obtain efficiencies of scale in acquiring their shares. Though each participating employee typically has an individual account within the trust, the actual shares and the administrative responsibility for managing the assets of the trust are conferred on a trustee that has the fiduciary obligation to operate the trust in the interest of the employees.[4] Because the shares are held in trust, they can more easily be managed as deferred employee benefits to facilitate long-term capital appreciation, either for a specified period of time or until reaching retirement rather than being sold for a short-term profit..

E. Leveraged ESOPs

ESOPs can also be used as a means of financing ownership stakes for a group of employees. To the extent that an ESOP is financed with borrowed money it is called a "leveraged ESOP". What

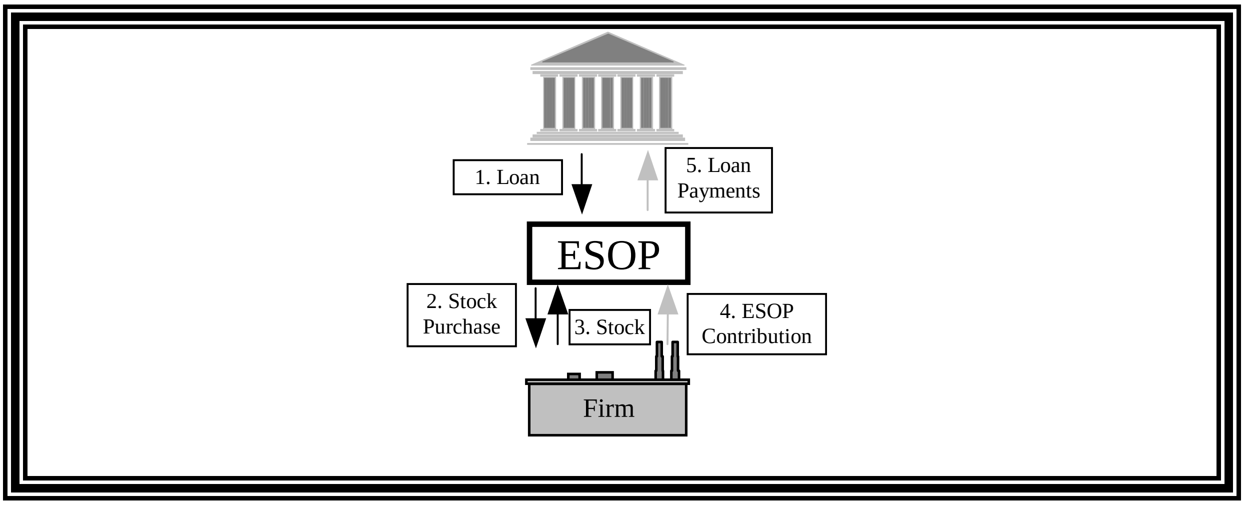
[4] ESOP Committees are commonly formed to oversee the administration of the trust and to provide guidance to the trustee on a broad range of issues. Such ESOP Committees commonly include the participation of both management and rank-and-file employees and are thus an effective means of providing employees with additional voice and influence in the management of their ownership stake.

distinguishes a leveraged ESOP from other employee ownership programs is that shares are paid for partly or fully out of future corporate earnings and/or dividends. This allows employees to obtain stockholdings significantly larger than what they can purchase with current earnings or personal savings. The fundamental principal underlying leveraged ESOPs is giving employees access to the capital credit of the company, and thus allowing them to "tap in" to the credit capacity of the sponsoring corporation. The concept is not much different than the debt-financed purchase of a first home or business.

The financing to acquire the stock for a leveraged ESOP can come from the selling government, from an outside buyer, a third-party lender, or from a combination of these sources, including negotiated workrule changes with employee groups and/or access to employee pension assets. The outside buyer and/or lender may be incentivized to provide credit in response to tax or other incentives or simply because the ESOP loan, backed by the guarantee of the sponsoring corporation, offers an acceptable credit risk.

Leveraged ESOP debt is typically repaid through via tax-deductible contributions made to the ESOP from the sponsoring corporation from future corporate revenues. The ESOP then transfers those funds to the bank and releases an equivalent number of shares from collateral for allocation to individual employee accounts within the ESOP. Dividends on stock owned by a leveraged ESOP can also provide "self-financing" to the extent that these dividends will be sufficient to repay the principal and interest necessary to liquidate the acquisition debt. A number of governments around the world offer favorable terms to ESOPs through discounts, subsidized loans and/or deferred payment terms, tax deductions to encourage corporations to fund ESOP contributions, or "earn-outs" in which employees and managers earn their ownership by meeting predetermined financial goals for the privatized company.

Exhibit III-1: Standard Leveraged ESOP



SECTION IV: INTERNATIONAL BEST PRACTICE FOR ESOPs

Employee ownership has been utilized in a variety of different legal, social and economic conditions in a broad range of developed and developing countries. Though the specific legal and administrative details of these plans differ from country to country, there is a general range of principles and practices that could be said to represent international best practice in employee ownership in the context of privatization initiatives. Some approaches are country-specific due to the special set of circumstances in which they were developed. Others are fairly universal and are being used in a number of different jurisdictions. Each country's culture, corporate, tax and legal framework, labor relations dynamics and overall economic climate will influence the approach to implementing an employee ownership strategy. In developing employee ownership programs, however, there are several key considerations that will help determine the overall strategic approach.

The following highlights those practices and principles governing the design, implementation and management of effective employee ownership programs that have been successful in facilitating the use of employee ownership around the world.

A. Employee Ownership Requires Policy Support

Privatization is a political process. It requires political will to get started and political savvy to ensure that it will be a continuous process that is perceived as fair by diverse interest groups. Properly designed and implemented, ESOPs offer a viable means of facilitating a privatization program by providing a key interest group – employees of state-owned enterprises subject to privatization initiatives – with an opportunity to make the transition to the private sector with a job and with a financial stake in the future success of their privatized company. Employee ownership is no panacea, but it does represent a practical and proven technique of accomplishing a needed public policy objective in circumstances where state-owned companies can be partially or entirely transferred to the private sector.

Successful employee ownership programs require strong government support. Absent government support for employee ownership reforms, the viability of employee ownership as a significant factor in privatization transactions will be limited. Employees lack the financial resources and the experience required to negotiate the complexities of financial transactions. Incorporating employee ownership in the privatization process therefore requires the creative application of a variety of employee ownership techniques that must be integrated within the legal and tax regimes in Mongolia today.

That support can include clearly-stated goals for employee participation in privatization programs, an active public education campaign, tax incentives to encourage companies and employees to invest in employee ownership programs, credit guarantees, liberal payment terms for employee groups, and technical assistance in implementing actual transactions. In addition, policymakers should consider what reforms may be needed to remove tax, accounting or legal barriers to the use of broad-based stock ownership in private sector companies and to facilitate the perpetuation of employee ownership in companies that are no longer state-owned.

B. Balance Privatization and Revenue Goals

Whereas a sale of government assets to the highest bidder may be the simplest and most direct strategy of privatizing state-owned enterprises, in the absence of strategic investors such an approach typically limits ownership exclusively to either well-connected insiders or to an economic elite. Such a strategy runs the risk of perpetuating old economic structures and raising questions about the benefits of privatization for the broad base of employees. Similarly, sales to strategic investors may provide much-needed capital and expertise and should be welcomed as part of the privatization process – but to what extent and for how long? Without assuring legitimate opportunities for its citizens to obtain ownership in the newly privatized economy, governments expose themselves to charges of selling off the national patrimony. The willingness of the government to subsidize employee share acquisitions or defer its income from the privatization transaction by allowing employees to pay for their shares over time can help ensure that employees will be able to obtain more than a token amount of stock ownership.

C. Integrate ESOPs into Overall Privatization Strategy

Employee ownership is but one element of a successful privatization strategy. ESOPs will be more successful if they are integrated into a conceptual framework designed to foster the growth of the domestic capital market and attract local and foreign direct investments to accelerate the privatization of state-owned enterprises. Attracting strategic investors who will provide capital, know-how, and potential openings for new markets to the privatized enterprise is another essential element of an overall privatization strategy. In that regard, the integration of ESOPs in privatized enterprises can be perceived as a positive development by foreign investors. Given the growth of employee ownership worldwide, many multinational companies are familiar with employee stock ownership and are increasingly receptive to ownership-sharing arrangements.

D. Provide Credit to Finance ESOP Transactions

Employees generally have a limited capacity for investing their own cash reserves in the shares of the company where they work. Employee groups are rarely able to bid directly on privatization proposals without assistance in the form of financing or some form of subsidy to facilitate their ability to acquire shares. Leveraged ESOP transactions are feasible if the government provides the winning bidder a contract term long enough to convince lenders of the ability of the newly privatized enterprise to meet debt payments. Alternatively, the government could allow for discounts on employee purchases of shares in privatized enterprise, allow deferred payment terms for purchases of stock, or create incentives for corporate contributions to ESOP participants.

E. Facilitate Long-Term Capital Appreciation, not Short-Term Speculation

ESOPs not only facilitate the use of credit but are also an effective means of perpetuating employee ownership by holding the shares in trust for employees in order to facilitate long-term capital appreciation. In some cases, ESOPs may also be used to help employees expand their ownership stake over time through additional stock acquisitions. Direct share ownership or stock options should also have restrictions to ensure long-term ownership by employees. To the greatest extent possible, the reward formula for workers and management must nevertheless provide for both long-term *and* short-term payoffs, however minimal. Optimally, deferred ownership rewards should not be the only payback for employees working through the privatization process.

F. Do Not Dictate Permissible Levels of Employee Ownership

In some instances, employee groups may be able to structure a complete employee buyout of a privatizing enterprise. In most cases, they will be required to partner with other investors. In the case of very large companies, the employee ownership stake may be relatively small in terms of percentage of shares owned but relatively valuable as measured by stock value per employee participant. The government can assist in determining the best feasible deal for employees without establishing arbitrary limits as to the amount of equity available to the employee group in a given transaction. Employee groups should be encouraged to negotiate for the best economic deal, not necessarily the largest ownership percentage.

G. Involve Employee Groups from the Beginning of the Process

Employee groups, in particular labor unions, are typically the biggest roadblock to privatization initiatives. Giving them a financial stake in the privatization can help counter potential opposition and provide them with a direct incentive to support privatization programs. But employees need to feel that they have an opportunity to affect the outcome and not have their fate determined by dynamics entirely beyond their control that prevent their active participation in the process.

H. Ensure Fairness of Opportunity, Not Necessarily Equal Outcomes

All employees should have an equal opportunity to acquire some stock ownership, though overly restrictive stock distribution rules should be avoided. Lenders to private employee buyout transactions often require that key employees be given greater performance incentives or require larger investments on the part of key executives. Some flexibility should be allowed in determining actual stock allocation strategies.

I. Balance Employee Ownership and Control

Employees need not manage or control enterprises in order for employee ownership to be successful. Enterprises going through the privatization process require competent, experienced managers in order to succeed in a competitive environment. While employees should be assured of many if not all of the rights and responsibilities of shareholders, including voting, access to information, dividends, etc., that will not always translate into employee control or worker self-management. That said, research clearly indicates that corporate performance can improve when employee ownership is combined with participatory management programs aimed at providing employees the opportunity to participate in decisions affecting their workplace. Such progressive management techniques should be encouraged and supported.

J. Use Different Employee Ownership Strategies as Circumstances Merit

An employee ownership strategy that is well-suited for small and medium enterprises may not work well for larger enterprises and visa versa. Privatization programs should be flexible enough to accommodate a variety of approaches to structuring employee ownership transactions.

K. Employees Should Not Be Buyers of Last Resort

Too often in privatization programs around the world, the employee ownership option only surfaces when no other buyers are interested in a particular state-owned enterprise. Employee buyouts may well be appropriate in certain circumstances where marginal companies may not be attractive to outside investors but could nevertheless operate successfully as an independent company. But employee buyouts should only be permitted in financially viable businesses and based on a sound financial feasibility analysis.

L. Establish Reliable Valuation Procedures

To ensure that the government gets a fair price for the value of its shares and that employees pay no more than fair market value for the shares they acquire, procedures for valuing State-owned enterprises should be clearly established. The procedures may vary between a competitive bid, a share flotation or a private placement for employees or strategic investors, but the valuation process should pre-established, transparent and subject to strict fiduciary standards.

M. Maintain Transparency of the Process

Ensure widespread distribution of information on ESOP strategies for privatization to employees of state-owned enterprises and to outside firms that may be interested in bidding on privatization transactions. In some instances employees may be the only bidders, whereas other companies subject to privatization may require a competitive bidding process. Enforce transparency standards for employee ownership companies after the privatization transaction as well.

N. Be Prepared to Manage Differing Expectations

Some will advocate employee ownership as a means to broaden the ownership of capital wealth. Others will view employee ownership as a means to enhance corporate performance. Still others will emphasize the benefits of making ownership available to a broad cross-section of employees to promote worker self-management. Employees may see employee ownership as a job preservation strategy. Investors may want to limit employee ownership stakes to maintain maximum investment flexibility. While these perspectives are not necessarily incompatible, different interest groups will approach employee ownership with different priorities.

O. ESOP Legislation Helps But is Not a Prerequisite

As this paper makes clear, strong policy support is essential for promoting widespread use of employee ownership. Towards that end, legal and regulatory guidelines are critical to ensure fairness and efficiency in employee ownership programs. But many employee ownership transactions have been successfully implemented as pilot projects, demonstrating that one need not wait for the ideal legal environment to emerge from legislative bodies. More often than not, there is adequate latitude in existing legislation and/or sufficient authority in government ministries to do something constructive. A successfully completed project will, in turn, expedite successful privatization in subsequent transactions and/or generate interest in the private sector for similar strategies. Developing legal, tax and operating guidelines that can apply to private sector employee ownership plans is therefore an imporant priority for ensuring broad-based interest in the private sector.

SECTION V: SAMPLE ESOP INCENTIVE

Virtually every country that has implemented employee ownership programs has developed some means of incentivizing or facilitating employee acquisition of shares. The following is a selection of various employee ownership incentives that have been adopted in different countries. Not all of these incentives will be applicable to a given jurisdiction but they illustrate the broad flexibility and range of choices available to policy-makers in crafting an employee ownership strategy.

A. Incentives for Companies

- Tax deduction for contributions made to the plan by the sponsoring corporation within certain limits, including contributions to repay ESOP debt.
- Allow company to apply pretax profits to buy shares for employees up to specified limits.
- Permit tax deduction for corporate matching contribution of employee savings deferrals to employee trust to purchase shares.
- Tax deduction on dividends used to repay debt that was used to acquire employee shares or paid in cash to employees based on their shareholdings.
- Tax deferral and/or reduction on the value of stock distributed to plan participants.
- Lower tax rates for meeting or exceeding minimum ownership levels by employees.
- Corporate tax reduction based on percentage of company owned by employees.
- Allow a tax deduction for the administrative cost of managing ESOPs.

B. Incentives for Employees

- Defer taxes on voluntary employee savings (and any interest earned) that are held in trust to purchase shares on option.
- Tax exemption on shares held in trust for employees (or subject to restrictions) until distributed to the employee.
- Tax exemption on dividends paid on shares held in employee trust.
- Discount for employees on stock purchased under an approved employee share scheme.
- Allow employees to defer income on pre-tax basis to purchase shares.
- Exempt employee shareholdings from social security taxes.
- Lower tax rates on distributions of employee shares held in trust for longer periods of time (typically 3-6 years).
- Tax credit up to 25% of salary for share purchases or investments in employee venture capital companies.
- Permit employees to purchase shares at asset valuation or book value prior to competitive bidding process by strategic investors.
- Tax exemption for dividends paid on stock acquired through the plan.
- Tax deduction for voluntary employee contributions used to repay ESOP debt.

C. Credit Support for Companies

- Permit sponsoring corporation to provide guarantee for ESOP loan, to be repaid out of future corporate earnings, with tax-deductible corporate contributions or dividends to the ESOP.
- Tax deduction for companies that make loans available to employees to purchase shares.
- Reduce taxes for banks on interest income from loans to ESOPs or other employee trusts.
- Reduce corporate income tax for lenders that commit a minimum percentage of their loan portfolio to ESOP loans.

- Allow employee-owned companies long-term leases of State-owned enterprises with 20% downpayment.

D. Credit Support for Employees

- Extended repayment terms for employee loans.
- Allow employees to use government pensions or severance pay benefits as collateral for loans to acquire shares in privatization transactions.
- Provide subsidized interest rates for employee loans to acquire shares.

SECTION VI: PRACTICAL CONSIDERATIONS FOR IMPLEMENTING ESOPs IN MONGOLIA

To operate successfully over an extended period of time, ESOPs will need to be ensured of the protection of legal certainty governing the operation of the plans and to conform with Mongolian corporate law. For both privatization transactions and for plans established by private companies, legal, tax and financial guidelines governing how the plans are structured, as well as procedural standards governing the operation of the plans are essential elements of an effective employee ownership strategy.

Obviously, employee share ownership will be optimized in an environment that clearly defines private property rights, securities laws, shareholder rights, including voting and rights to information disclosure, and the provision of mechanisms for employees and other shareholders to sell their shares. The development of efficient domestic capital markets is particularly helpful in the context of employee ownership. Efficient capital markets provide the privatized enterprise with a means to access much-needed, long-term capital to fund their growth. In addition, they strengthen ESOPs because they provide a source of liquidity for the shares acquired by employees. Without such a liquidity mechanism, provisions must be made by the company or the ESOP itself to repurchase the shares of their employees. In cyclical downturns or in times of difficulties for the company, this repurchase liability can worsen the company's financial health and create additional cash demands that depress share values.

The legal and operating guidelines for ESOPs will need to address the following issues:

A. Policies Regarding the Use of ESOPs in Privatization Transactions

The government should determine the extent to which it will facilitate the use of ESOPs in the context of privatizing state-owned enterprises and develop guidelines for the potential use of ESOPs in privatization transactions.

In the context of privatization initiatives, the government has a unique opportunity to design ownership strategies to promote widespread capital ownership of productive assets. Employee ownership plans will be a central element of such a strategy but efforts to encourage wider participation of employees in shareholding, promoting the development of capital markets and encouraging the creation of new entrepreneurial businesses should all be part of a larger public strategy to promote widespread participation in ownership. Such a program requires clear goals, consistent messages and a long-term commitment to public outreach and education regarding the privatization process and attendant policy goals.

B. Employee Trust Funds and Related Employee Stock Plans

Legal standards need to ensure that ESOP trusts or similar funds will be recognized as legal shareholders. The taxation of shares contributed to, acquired by, held by and distributed from the ESOP should also be addressed with respect to both corporations and employees. Similarly, government should clarify its policy with respect to the tax treatment of employee stock options and other means of sharing ownership with employees. These rules should address both privatization transactions and the operation of employee ownership plans by private companies.

C. Rules governing the operation of ESOPs

Legal and administrative guidelines should be established to ensure equitable treatment of participants in ESOPs and to ensure proper accounting of shares held in trust on behalf of employees. Issues such as how shares are initially acquired, recordkeeping and information disclosure, how shares are allocated to employees over time, who is eligible to participate and on what terms, when the shares can be sold, how the record-keeping and communications procedures will be implemented, voting and representational reights, etc. will all be crucial to how the plan will be perceived by employees.

D. Fiduciary Standards and the Roles and Responsibilities of Plan Trustees

Rules governing the responsibilities – and liabilities – of plan trustees should be established to ensure that the assets held in ESOP trusts are managed exclusively in the interests of plan participants. Fiduciary standards should apply to both the management of plan assets, information and disclosure requirements for plan participants, procedures for interacting with employee committees and for facilitating employee voting rights on shares held in their respective accounts within the plan.

E. Valuation Standards and Procedures

There are many different approaches to establishing the value of corporate shares. For privatization transactions involving competitive bids by strategic investors the share value will typically be determined in large part by the value of the bids. Similarly, a privatization involving a share flotation will be valued according to the shares traded on the stock market.

Some employee ownership transactions are likely to involve sales of stock to employee ownership plans directly from the state. The employee ownership transactions could take place prior to or in conjunction with a private placement with a strategic investor. For both the selling shareholder (the Government of Mongolia) and the purchaser (the employees of state-owned enterprises) it will be exceedingly important to establish initial and ongoing standards for determining the fair market value of the shares. This is typically done by retaining the services of an independent appraisal firm that conducts an arms-length appraisal of the enterprise and provides an opinion as to the appropriate enterprise value. Such an analysis would include a comprehensive assessment of the company's earnings, cash flow and market position, including comparisons with comparable companies in its line of business.[5]

Some countries have used alternative approaches to valuations, for example by allowing employees to buy shares based on a valuation of the assets before competitive bids are solicited for the entire enterprise. Whatever approach is ultimately developed, it is essential that consistent and reliable standards be established for valuation methodologies to ensure transparency and fairness in the sale of state assets to employees. Procedures should also be established for updating valuations at least annually.

F. Sample Plans

Optimally, the government could develop approved plans that can be easily adopted by companies looking to implement them in the private sector as well as in privatization transactions. More complex transactions may require more specialized design features, but a standardized plan or plans can greatly facilitate the implementation process for most companies.

[5] For a detailed discussion of the process of valuing shares in the context of employee ownership transactions, see "Valuing ESOP Shares", The ESOP Association (USA). www.esopassociation.org

SECTION VII: CONCLUSION

Over the past 20 years dozens of countries have utilized some form of employee ownership in the privatization process. The employee ownership component of privatization has ranged from a token that had little or no impact, to an essential element of the privatization process. In some instances there was a bare minimum of legislative authority, with programs created and implemented by governmental ministries. On the other extreme, the U.S., with over twenty pieces of legislation passed since 1973 that directly affect ESOPs and other employee ownership plans, and the U.K., with five different types of approved employee share schemes, have comprehensive legal structures that govern the use of employee plans in both private sector transactions as well as in privatization initiatives.

The fundamental concept of employee ownership is to provide employees with access to credit to acquire productive assets. As was discussed in some detail in this report, it is only when credit is made available in some form to employees, either directly or indirectly, that widespread sustained employee ownership occurs.

Employee ownership has been a factor in small privatization transactions as well as in quite large ones. In some cases, employees have successfully completed buyouts of entire enterprises; in others they are minority partners with other strategic investors. In most countries, the government has provided some form of subsidy to facilitate employee acquisition of shares in the context of privatization programs.

Where extensive research has been done in countries such as Poland, the U.K. and the U.S., there is a strong body of data illustrating the positive economic impact of employee ownership on corporate performance when combined with participatory management techniques. In other cases such as Russia, employee ownership programs failed due to an insufficient regulatory structure for the protection of shareholder rights. In other cases privatized companies were unable to successfully compete in the private sector.

Employee ownership can work effectively, but it requires careful attention to the appropriate transaction design, the legal and tax environment, regulatory support structures and the ability to restructure businesses to compete effectively in the private sector. The challenge for Mongolia is first develop policies governing the use of ESOPs in the context of privatization of state-owned enterprises and to integrate that strategy with the creation of a tax and legal infrastructure to help ensure that ESOPs and related employee stock plans can work for the benefit of companies and employees alike to help promote the continued economic growth of Mongolia’s private sector.

ANNEX A: SUMMARIES OF SELECTED COUNTRY-SPECIFIC LAWS GOVERNING ESOPs

ANNEX A: SUMMARIES OF SELECTED COUNTRY-SPECIFIC LAWS GOVERNING ESOPs

The following provides a synopsis of key characteristics of employee ownership policies adopted by selected countries. Many, but not all, of the various employee ownership policies are specifically intended to facilitate the use of employee ownership in privatization transactions. Unless otherwise indicated, the laws and policies apply equally to private sector firms as well as state-owned enterprises slated for privatization.

A synopsis of the following countries' employee ownership policies are included in this Appendix:

- Australia
- Bolivia
- Canada
- Chile
- China
- Egypt
- El Salvador
- France
- Hungary
- India
- Ireland
- Jamaica
- Poland
- Russia
- Slovenia
- Spain
- Trinidad & Tobago
- United Kingdom
- United States

AUSTRALIA

Australian laws provide some support for ESOPs and stock options, though the benefits are primarily available to listed companies, not privately-held firms.

1. Division 13A of the Income Tax Assessment Act defines a qualifying ESOP as any plan which offers at least 75% of permanent employees of 3 years standing an ordinary share, or right thereto, in the employer's company;
2. Employer contributions to an ESOP are fully tax-deductible;
3. Employees can receive up to $1,000 per year of tax-exempt shares under a qualified ESOP;
4. Employees can defer tax liabilities on ESOP shares for up to 10 years;
5. The tax-exemption is available up to a limit of 5% of the firm's voting shares per individual employee;
6. The law also provides 10-year employee tax deferral on share options;
    - Option plans are exempted from the 75% rule regarding employee participation.

Source: Australian Employee Ownership Association *http://www.aeoa.org.au/policy.html*

BOLIVIA

For the divestiture of its largest state-owned companies, Bolivia developed an innovative two-step process known as "privatization by capitalization."

1. The state-owned companies were first transformed into mixed-ownership companies instituted jointly by the government or some other public sector entity and private capital.
2. Employees were offered the opportunity to buy one share of the new company. The purchase gave them a preferential right to "underwrite" shares of the new company. The preferential right took the form of an option contract.
3. The company then doubled its number of shares, with the newly issued shares offered for sale to strategic investors.
4. The state contributed its diluted stake in the company (50% minus one share) to a series of pension funds created to provide Bolivian citizens with a pension upon retirement.
5. The option contract formed part of the government's offer to employees, subject to the condition that at least one employee buy one single share in the company. By doing so, they gained the right to buy the shares owned by the state or public shareholder at book value, up to the total of their social benefits, after the results of the international public bidding to select the strategic investor were known.
    a. Thus, employees were not required to commit or risk any capital, except for approximately $20 for a share, and they only had to decide whether they would buy additional shares after the results of the bids were in, that is, once they knew whether the winning bidder paid more than the book value.
    b. In most cases, employees were allowed from 15 to 30 days after the date of the award to exercise the option and sign a contract to purchase shares.
    c. The contracts allowed for the shares to be paid up over periods ranging from 12 to 24 months with a minimum deposit of 5 percent of the total purchase price as an additional means of facilitating participation by employees.
    d. The shares were quoted on the Bolivian stock exchange after 50 percent of company shares had been sold and the capitalized company was being operated by the private sector.

Source: Santiago A. Nishizawa and José A. Valdez "Employee Participation in the Capitalization Process in Bolivia," June 1997.

CANADA

Canadian federal law makes few specific references to ESOPs, but several of Canada's provincial governments have implemented legislation to encourage the development of employee ownership.

British Columbia

British Columbia's "Employee Share Ownership Program," encourages employees to make tax-favored investments in British Columbia companies where they work.

1. The program provides for three specific types of employee investment:
   a. the standard ESOP;
   b. the successor ESOP, must provide employees with the opportunity to acquire a controlling block of shares within a reasonable period of time;
   c. the cooperative ESOP, which must provide for one-person/one-vote governance.

   The plans vary slightly but generally share common requirements regarding eligible employees, eligible companies, valuation procedures, liquidity requirements, voting and fiduciary standards.
2. Provides employee investors with a tax credit incentive of up to 20% of pay, subject to an annual maximum of $2,000 and a lifetime maximum of $10,000, providing they hold the shares for a minimum period of three years.
3. Employee Venture Capital Corporations (EVCC) enable employees to purchase shares in their own holding company (an entity established to hold the shares of one or more operating companies), that in turn invests in the company that employs the employee investors.
   a. EVCC investors are eligible to receive a 15% federal tax credit on their investment, to a maximum of $750 in any one year.
   b. Penalties apply for selling shares prior to the end of the 3-year holding period.
   c. Any B.C. company with less than $50 million in total consolidated assets and which pays at least 50% of its wages to employees resident in B.C. is eligible to register an EVCC Plan under the program.
   d. A maximum of $5 million can be invested in a company over a two-year period.
   e. Businesses involved in retail sales or service, primary resource exploration or extraction, financial services, property management, real estate development or traditional agriculture are not eligible.
   f. An EVCC must have at least $25,000 in equity capital at the time of registration and must invest at least 80% of the equity capital raised in the eligible business within 12 months of the fiscal year in which it was raised.
4. For both ESOPs and EVCCs the province provides assistance in the form of cost sharing with the employer, sample documents and other materials, and consultation with program staff to ensure successful registration. Cost sharing assistance for up to 50% of feasibility assessment costs is available to small- to medium-sized businesses and all employee groups for professional fees incurred in establishing a plan.

Saskatchewan

Saskatchewan's Employee Investment Program is designed to help employee groups and individuals by contributing to funds which invest in small and medium Saskatchewan-based businesses, in order to create or maintain jobs. To utilize the program, a minimum of 5 employees form and register a corporation that purchases shares in their employer's company on their behalf. The employees' investment is eligible for federal and provincial tax credits.

1. Eligible businesses must:
    a. be corporations or co-operatives;
    b. have between 5 and 300 employees, who currently reside in Saskatchewan;
    c. pay at least 25% of their salaries and wages to Saskatchewan residents
2. Investors receive a 20% provincial tax credit on the first $5,000 per year per investor, and a 15% federal tax credit on the first $5,000. Tax credits are available only to the first purchaser of shares.
3. Eligible investors are residents of Saskatchewan on the last day of the taxation year and an employee of the eligible business or an associated corporation of the eligible business.
4. An employee-controlled investment fund must be established to facilitate investments;
    a. the fund must be incorporated by the employee association;
    b. the fund may not issue equity shares for a total value in excess of $5 million;
    c. the fund must provide for equal opportunity for all employees to purchase shares which are participating, voting, and share in the proceeds upon dissolution;
    d. an employee holding shares in both the fund and the business it invests in may not hold more than 10% of the shares of either;
    e. investments must be held for eight years or tax credits must be repaid;
    f. the fund is required to invest in the employer company within 6 months.

Nova Scotia

Nova Scotia's Equity Tax Credit is designed to assist Nova Scotia small businesses, co-operatives and community economic development initiatives in obtaining equity financing by offering a personal income tax credit to individuals investing in eligible businesses.

1. The credit is available to residents of Nova Scotia who are over 19 years of age and who have bona fide reasons for making the investment, other than simply obtaining the tax credit. Each eligible issue of shares must have at least three eligible investors.
    a. The tax credit is calculated at 30% of the investment made by the individual to a maximum annual investment of $30,000 (maximum annual credit of $9,000).
    b. The investment may be made within the calendar year or within 60 days of the end of the taxation year.
    c. The credit is not refundable but may be carried forward for seven years or carried back three years.
    d. The maximum credit that can be claimed in a single taxation year (including current year and the carry forward or back amounts) cannot exceed $9,000.
2. Investors are required to hold the investment for at least four years. If an investment is disposed of, within this four year period, the individual may be required to repay the tax credits earned.

3. In the case of corporations, eligible investments must be newly issued common voting shares of the corporation that are non-redeemable, non-convertible and are not restricted in profit sharing or participation upon dissolution.
4. In the case of co-operatives, eligible investments must be a share that would, if it were the only share issued to the investor, allow the investor to be a member in the co-operative and allow the member to participate in the affairs of the co-operative.
5. Eligible businesses include corporations and co-operatives incorporated pursuant to the laws of Canada, including CED corporations and co-operatives. CED corporations and co-operatives are those organizations created to assist or develop local businesses within the community. The CED corporation or co-operative raises capital by issuing shares to individuals and in turn invests that capital in local businesses.
6. Eligible businesses must meet the following criteria:
    a. be involved in active business or investing in other eligible businesses,
    b. have less than $25 million in assets,
    c. pay at least 25% of salaries and wages paid in Nova Scotia,
    d. corporations must have authorized capital consisting of shares without par value,
    e. co-operatives must be marketing, producing or employee co-operatives,
    f. corporations must have at least three eligible investors taking part in the specified issue.

Sources: ESOP Association Canada [*http://www.esop-canada.com/*](http://www.esop-canada.com/)
Employee Ownership & Incentives Association [*www.esopcanada.org*](http://www.esopcanada.org)

CHILE

Chile developed a strategy for "labor capitalism" in order to build support for its privatization program.

1. As a general rule, workers were offered 5-10% of a privatized company's shares at a discount price.
2. To pay for the shares, workers were allowed to borrow up to 50% of their severance pay, with the company promising to repurchase the shares at retirement at a value at least equal to the foregone severance payments.
    - Thus, employees could buy shares at below market price with no cash outlay, with no risk of loss, and a potential for gain if the shares increased in value.

CHINA

Though the word "privatization" is not acceptable to the Chinese government, they have nevertheless introduced experiments in "social ownership," whereby workers in large factories can receive stock ownership in their companies. Many of these experiments in employee and village ownership are governed by local rules. Though China has no specific national legislation governing employee ownership, legislation developed for the Hainan Special Economic Zone is specifically designed to promote the use of employee ownership.

1. A company's owner, shareholders and elected employee representatives of the employees must agree on the establishment of the employee ownership plan. In state owned companies, employee ownership will be adopted when companies are transformed into private enterprises, with the consent of the employees.
2. Government authorities are directed to provide "appropriate" (but unspecified) tax relief to lenders to employee ownership plans, employees purchasing shares, and/or companies setting up such plans.
3. The plan is intended to operate in a non-discriminatory way with respect to participants.
4. Shares for employees can be acquired when the company is privatized or when an existing company increases its authorized shares. Employees can obtain shares by:
    a. purchase;
    b. conversion of property rights of the company into shares at the time the company is privatized;
    c. the granting of shares by the company in return for "human capital";
    d. withholding 15% to 25% of employee wages, with the approval of the individual employee and the employee assembly;
    e. loans from banks to the employees or the company;
    f. purchase of shares using existing employee welfare funds;
    g. purchase out of corporate reserves;
    h. conversion of state-owned shares;
    i. withdrawals or conversion of up to 20% of the net assets of a restructured enterprise upon conversion;
5. For each employee shareholder, at least half the shares must be obtained through a direct or indirect purchase (such as conversion of welfare funds).
6. Contributions from the chairman of the board or general manager shall not exceed five times that of any other individual employee. Companies can, however, adopt stock option plans for management.
7. 10% of the shares initially set aside for employees shall be set aside for future employees. This amount will be augmented by shares repurchased from departing employees.
8. An employee trust is the entity for buying, holding, and selling of shares. Each employee has an individual account within the trust.
9. Employee rights, including voting for trustees, will be in proportion to their shareholding and will be on such issues as the contract specifies.

   a. Employees can elect the trustees and serve on the board of directors if elected.
   b. Employees must be able to vote on the contract and any change in the contract, the election of the company's board and the trustees of the trust, and any change in the number of employee shares. Each of these issues requires a two-thirds majority vote. Other decisions require a majority vote.

10. Any dividend paid will be paid to employees in proportion to their shareholding.
    a. With shareholder approval, dividends may be reinvested in the company.
    b. Dividends reinvested in the company may be exempt from employee taxation.
11. Trustees are personally liable for their breach of the trusteeship contract.
12. Employee shares cannot be withdrawn, assigned, or transferred except according to the specific rules described below.
    a. Retiring employees can keep their shares or sell them back to the trust.
    b. When an employee dies, leaves the company, or is fired, his or her shares are bought back by the trust at its discretion.
    c. Shares from deceased or retired employees will be bought back within one year; from other employees in three years on a piecemeal basis.
    d. Transactions will be at net asset or market value.
13. Employees can, while still employed, sell shares back to the trust provided they have held the shares for at least three years.
14. Reacquired shares held by the trust will be transferred to other employees according to the various means of acquisition described above at net asset value or market price.
15. Funds for repurchasing shares will come from funds from employee purchases of shares, dividends, loans, and other "legal sources", presumably including current corporate income.

Source: NCEO www.nceoglobal.org

EGYPT

Because Egyptian law does not recognize trusts, Egypt has approved the use of “Employee Shareholder Associations” (ESAs) to acquire and hold shares on behalf of employees in privatization transactions. These shareholder associations hold shares on behalf of employees. The ESA must be given the opportunity to purchase at least 10% of the shares in a privatization transaction.

1. An ESA can acquire shares by means of:
   a. conventional bank loan;
   b. through an agreement with the company to purchase the shares over time (typically 10 years or more) or , more commonly;
   c. by receiving special government financing for the acquisition of shares
2. Most ESAs acquire a partial ownership interest, typically in a joint agreement involving the government and private investors. There are some majority-owned ESAs although they have mostly been established in businesses where a strategic outside investor was unavailable.
3. Employee members of the ESA receive share allocations in their association accounts and upon departure from the company receive the cash value of their stock accounts.
4. ESAs can be established in any company that has a capital base of not less than E£1 million, at least 50 employees, of which at least 20 are members of the ESA.
5. The ESA share ownership percentage cannot drop below 5% of the value of the company’s nominal shares at any time. If less than 5% of the corporate securities are owned by the ESA, the plan is automatically disqualified.
6. ESA membership is comprised of employees currently working in the company who choose to participate. Membership ceases upon termination of employment or an employee’s decision to withdrawal from the plan. If an employee terminates membership in the ESA he/she has the right to redeem his/her share account based on the last balance sheet valuation.
7. A member's right in an ESA is limited to the receipt of share dividends. The member has an interest in the ESA. The ESA is a stakeholder in the company. Each member’s allocations in the ESA are considered unique and recorded individually.
8. An ESA is governed by a Board of Directors and the Employee General Assembly consisting of all participants of the ESA.
9. In the initial design of the ESA a 3-person “founding committee” is elected based on a vote of all members of the ESA. The founders file all appropriate papers and documentation in order to register the ESA with the Capital Market Authority and to solicit comments and suggestions from members on the design of the ESA.
10. After the founding of the ESA a Board of Directors is elected consisting of 3-5 members which is
11. Responsible for most operational decisions

12. ESA shares cannot be sold to anyone but ex-employees without the consent of the majority of the general assembly. The general assembly only has voting rights regarding the design and operation of the ESA. The voting rights of the general assembly do not extend to the management of the corporation.
13. Employee interests in the ESA are tax-free until payment upon termination of employment. All distributions are taxed at marginal personal income tax rates.
14. Employees who receive distributions from an ESA account (upon termination of employment or election to withdrawal from participation) do not receive any special tax relief.
    a. The value of the distribution is based on the computed value of the ESA's last approved balance sheet.
    b. The ESA must distribute payment to the employee within three months from an employee's termination in the ESA.
15. The percentage of the shares attributed to the ESA is taxed on a varying rate dependent on the percentage of ESA ownership.
    a. The first 10% of share ownership to the ESA is free from corporate level taxes, meaning the ESA company would not pay 10% of its tax bill.
    b. Additional ESA allocations/ownership levels above 10% to 20% are taxed at decreasing marginal corporate income tax rates.
    c. Above 20% ESA ownership all shares are taxed at normal rates.

EL SALVADOR

In the privatization of four electricity distribution concessions, employees of the state-owned electric company were given the opportunity to purchase shares under favorable circumstances.

1. Up to 20% of the shares of each of the four privatized companies were available at a pre-established price of 80% of the net asset value per share as of the beginning of the offer period.
2. Loans were made available to employees at less than half of the commercially available rates.
3. In each separate distribution concession, employees of that company were permitted to purchase shares only in the company for which they worked. However, employees of the central power generation company that owned the four distribution concessions had the right to buy shares of any of the four concession distribution companies.
4. In addition to setting aside the 20% of the shares for sale to the concession employees, the government also withheld 5% of the shares to sell on the stock exchange. The unsubscribed employee shares were added to this total and sold to the public at large.
5. The remaining shares were sold to strategic investors based on an open, competitive bidding process. Each of the four concessions attracted one or more strategic buyers.

FRANCE

French legislation offers a legal framework and generous tax advantages to a variety of financial participation forms, with a particular emphasis on profit-sharing.

1. Voluntary cash-based profit-sharing (Intéressement des salariés de l'entreprise) apply to all companies regardless size, type of business, or legal constitution.
    a. The plan must be the outcome of a collective agreement for three years negotiated between the employer and employee representatives and must specify the calculation basis for the profit-sharing, how it is allocated to employees, and arrangements to keep workers informed.
    b. Profit-sharing bonuses are subjected to income tax and the general social security contribution but free of social charges. The bonus is, however, deductible from income tax if it is allocated to a company savings plan (PEE) where it is held in trust for five years.
    c. For the employer profit-sharing amounts are deductible from corporation tax or income tax and exempt from all taxes, charges or contributions on wages, in particular social charges.
    d. In order to benefit from tax concessions profit-sharing schemes must cover all eligible employees, the bonuses must contain an element of risk and be calculated based on the performance of the company, and the maximum permissible contribution is 20% of total gross payroll.
2. Compulsory deferred profit-sharing (participation aux fruits de l'expansion) apply to all firms with a minimum of 50 employees. Smaller companies can adopt the scheme on a voluntary basis.
    a. The plans must follow a standard legal formula for profit-sharing, or another well defined formula that guarantees workers an amount no less than the legal standard.
    b. Profit sharing contributions in excess of the legal formula qualify for a tax free investment of 50% of that supplement.
    c. Allocation of the funds to the employees is based on salary, subject to certain limits, and the accumulated deferred profit sharing funds are held in trust for 3-5 years.
3. Company savings plans (PEE) is a system of collective savings to allow employees to constitute, with the aid of the employer, a portfolio of securities.
    a. PEEs are the vehicle for employee share ownership. It can be introduced on the initiative of the employer or by an agreement with the employees.
    b. PEEs can be funded by either voluntary savings by the employee, matched by a contribution by the employer (abondement); by the sums received from compulsory profit-sharing during and after the retention period; or by sums received from cash-based profit-sharing.
    c. If the savings are held for a minimum of five years they are exempt from social security contributions up to a limit of half the yearly social security ceiling for

wages. The employer's contribution to the plan (which is obligatory) is non-taxable for the employee.

d. Employee representation on company boards is compulsory for companies that are to be

e. Privatized and optional for firms in the private sector, if employees hold more than 5% of the capital.

f. More than 17,000 French companies have signed Participation Agreements whereby employees who work in the company are eligible to receive benefits in the form of share ownership.

Source: Erik Poutsma, Nijmegen Business School, Univ. of Nijmegen, The Netherlands, Delivered at the European Foundation for the Improvement of Living and Working Conditions, 2000

HUNGARY

The Hungarian privatization legislation gave strong preference to the use of leveraged ESOPs. This ESOP law is a stand-alone provision of Hungarian law in the sense that it is not specifically integrated with any other Hungarian pension legislation. These tax incentives therefore apply specifically to ESOPs used in the context of privatization without reference to other aspects of the law.

1. Employee groups that organize themselves into ESOP companies and purchase the company's shares upon approval of at least 40% of the company's employees.
2. ESOP companies qualify for a tax deduction for up to 20% of its pretax profits to fund an ESOP or to repay ESOP-related privatization debt for property purchased from the state.
3. Dividends are deductible by the corporation, if the dividends are applied to debt repayment.
4. ESOP participants receive a tax deduction equal to any voluntary contribution made to repay ESOP debt up to 30% of their income.
5. The ESOP itself is exempt from corporation tax and employees pay no taxes on their ESOP shares until they are sold.
6. ESOP loans are limited to 50% of the resale value of the shares.
    a. A required down payment of 2%, 15%, or 25% is based on a formula linked to the average price per participant for those shares proposed for ESOP financing.
    b. Payments can be spread over a 15-year period, with an optional 3-year grace period of interest payments only.
    c. The interest rate is 3% plus the intermediary bank's 4% margin.
    d. Banks may lend up to 85% of the value of the shares.
    e. ESOP participants are exempt from collateral requirements since the company can provide any loan guarantees required by the lender.
7. Acquisition of ESOP shares is exempt from the stamp duty.

Source: Janos Lukacs, Director Share-Participation Foundation, Budapest.

INDIA

Under Indian law, the term "ESOP" includes stock purchase, stock option, trust-based arrangements, or stock appreciation rights.

1. A written ESOP plan document must specify:
   a. the total number of shares that may be issued under such plan;
   b. the class of employees who would be entitled to participate;
   c. the pricing formula on the basis of which shares would be allotted to the employees, including the price at which such shares are offered at the time of grant or exercise of option;
   d. the number of shares or stock equivalents which would be issued to any employee or classes of employees and the basis of such award, if any;
   e. the period by and the manner in which the approval of shareholders would be obtained;
   f. the lock-in period of such shares from the date of option or exercise of option or purchase of shares under such scheme or plan, as the case may be;
   g. if the shares are unlisted, the basis of valuation of shares with reference to the company's account for the last three financial years and a brief explanation as to how the basis was arrived at;
   h. the conditions relating to restriction on non-transferability of such shares.
2. Any employee who directly or indirectly holds more than 10% of the outstanding equity shares of the company shall not be eligible to participate in such Plan.
3. Every company issuing ESOP shares directly or through its parent to its employees must file a copy of the plan document with the Chief Commissioner of Income.

Under regulations established by the Securities Exchange Board of India, ESOPs must comply with the following guidelines:

4. Companies must constitute a Compensation Committee for administration and management of the ESOP.
   a. the Compensation Committee must be a Committee of the Board of Directors consisting of a majority of independent directors.
5. The Compensation Committee formulates the detailed terms and conditions of the ESOP, including:
   a. the number of options/shares to be granted under an ESOP per employee and in aggregate;
   b. eligible employees;
   c. pricing formula;
   d. the term and exercise period of the options;
   e. employee rights concerning exercise;
   f. vested in employees may lapse in case of termination of employment;
   g. the procedure for cashless exercise of options.

6. The company may not vary the terms of the ESOP in any manner which may be detrimental to the interests of the employees.
7. There is a minimum period of one year between the grant of options and vesting of option.
8. The employee does not have a right to receive any dividend, to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to him, till shares are issued on exercise of option.
9. Option granted to an employee are not be transferable;
10. In the event of the death of employee, all the options granted to him till such date shall vest in the legal heirs or nominees of the deceased employee.
11. In the event of resignation or termination of the employee, all options not vested as on that day shall expire. However, the employee is entitled to retain all the vested options.

Source: ESOP Direct http://www.esopdirect.com/rulesandregulations.html

IRELAND

The Finance Act of 1982 was designed to encourage the voluntary and widespread adoption of share based profit sharing. To that end, government offered tax concessions for companies and their individual employees. However such concessions would only be granted to companies establishing approved schemes. These were share-based profit sharing or employee shareholding schemes which met certain government requirements.

1. The company must establish a trust fund to acquire shares on behalf of participating employees. Plans must be submitted to Revenue commissioners for approval.
2. Participation in approved schemes must be open to all full- and part-time employees and all employees must be eligible to participate on similar terms (either equally or based the level of remuneration).
3. Shares issued to participants must meet the following requirements:
    a. Must form part of the ordinary share capital of the company or its parent company;
    b. Must be shares of a class quoted on a recognized stock exchange;
    c. Must be fully paid up, non-redeemable, and free of any restrictions other than those which attach to all shares of the same class;
    d. Closed or private unquoted companies were not precluded from establishing approved schemes, provided the Revenue Commissioners are satisfied with their method of share valuation.
4. The company then contributes its profit sharing contribution to the trust, which is used to purchase shares in the company on behalf of all eligible employees. Alternatively, a company can contribute a block of its own newly issued shares as its profit sharing contribution.
5. Trust shares must be credited to accounts of individual participants.
    a. Shares are held in individual employee accounts for a minimum period of two years.
    b. Beyond the obligatory retention period, employees can instruct trustees to release, sell on their behalf, or retain their shares.
    c. Employees who instruct trustees to sell or transfer shares to their name will be liable for income tax. The extent of this liability will vary inversely with time elapsed from the end of the retention period.
    d. Maximum tax advantage is available to participants who allow the trustee to retain their shares for three years from the date they were first acquired by the trust. Beyond this period, shares held in trust are automatically released or transferred to individual employees free of any liability for tax though they may be liable for capital gains tax.
6. A company that establishes an approved profit sharing/employee shareholding scheme is allowed to deduct the value of its profit sharing contribution, be it in cash or its equivalent in newly issued shares, from its taxable income, up to 100% of trading profit less deductions and losses.

The 1997 Act introduces the concept of an Employee Share Ownership Trust (ESOT) to enable share to be acquired, held and allocated to employees. The ESOT can raise a loan or borrow to acquire shares in the company that established it.

7. At the time the Trust is established the company must be an Irish resident company and cannot be under the control of another company. Shares in the founding company cannot be acquired by the trustees at any time after the founding company falls under the control of another company e.g. a take-over. Shares purchased or received by the ESOT must form part of the ordinary share capital of the company. Finally employees or directors having a material interest, that is 5% of ordinary share capital, are excluded as beneficiaries of the scheme.
8. Once established, the ESOT can take out a loan, guaranteed by the participating company, or receive cash contributions from the company, which are tax deductible. There are three alternative trustee models allowed under the legislation.
   a. The first model provides for employee control with the majority of trustees being employee representatives.
   b. A second model allow for a balance of power between the employer and employee,
   c. The third allows for a majority of management appointees. All models must have one professional independent person approved by the Revenue Commissioners.
9. Using the proceeds of a loan, the ESOT can purchase shares in the company and the company can make a tax deductible cash contribution to an associated Approved Profit Sharing Scheme (APSS). The APSS passes this contribution to the ESOT in return for a block of shares in the company.
10. The APSS allocates the shares bought from the ESOT into the names of individual employees.

Source: Erik Poutsma, Nijmegen Business School, Univ. of Nijmegen, The Netherlands, Delivered at the European Foundation for the Improvement of Living and Working Conditions, 2000

JAMAICA

Jamaica's privatization program includes a comprehensive set of incentives for employee ownership in both private and privatizable companies, with legislation providing for share grants, share discounts, and loans on favorable terms. Incentives are directed at ESOP participants, sponsor companies, and lenders.

1. ESOP participants are permitted
    a. a tax deferral on shares allocated to their ESOP accounts,
    b. a tax exemption on personal funds (salary deductions, bonuses, or retroactive pay increases) used to acquire shares,
    c. a personal deduction for 25% of the principal and 100% of the interest for servicing a loan used to acquire shares,
    d. dividends received on ESOP-held shares are exempt from tax,
    e. shares held in an ESOP for more than six years are received tax free.
2. ESOP sponsors qualify for a number of incentives:
    a. Where a company loans its funds to employees to acquire shares, the company can claim a tax deduction equal to one third of the amount lent (50% where the board of directors includes at least one employee-elected director).
    b. Where a company borrows funds from a lender and either (a) on-lends those funds to employees to buy shares, or (b) makes a grant to the ESOP to acquire shares, this expense is deductible to the extent of 100% of interest payment and 25% of principal payments (50% for companies with at least one employee-elected director).
    c. Where a loan is made directly to an ESOP and the company is obliged to make grants to the ESOP to repay the loan (that is, a leveraged ESOP), the company can deduct 100% of that expense.
3. ESOP lenders qualify for:
    a. An exemption on 50% of the interest earned on ESOP loans.
    b. This exemption increases to 100% for loans that result in an ESOP acquiring 15% or more of a company's shares.
    c. A one percentage point reduction in the rate of corporate income tax (up to five percentage points) for each 3% of their total loan portfolio that consists of ESOP loans.

Source Jeffrey R. Gates and Jamal Saghir, "ESOPS, Objectives, Design Options and International Experience" (Washington, D.C.: Cofinancing Services, World Bank, September 1995).

POLAND

In 1990 the Polish Parliament approved legislation establishing a mechanism for employee buyouts of small and mid-size companies (i.e., companies with fewer than 1,000 employees). Since that time over 1,000 Polish state-owned enterprises employing approximately 300,000 people have been privatized under the lease liquidation method, which is fundamentally a leveraged buyout of an SOE using credit provided by the state. The majority of these privatized companies are majority owned by employees.

1. The value of the Company Funds of the SOE is determined by the Ministry responsible for the SOE. This used as a proxy for the value of the company itself.
2. A new employee owned company is then established by the majority vote of the current employees of the enterprise.
    - To acquire the lease, employees must pay an initial 20% of the purchase price as determined by the valuation of the Company Funds.
3. After the ministry and employee group agree upon the amount and length of lease payments, which typically are 7-10 years, and the 20% down payment has been made, 100% of the company's shares are transferred from the ministry to the new company.
4. The ministry maintains a lien against the company's shares pending the fulfillment of the terms of the lease.
5. The new company is fully responsible for all corporate tax payments and other liabilities once the terms of the lease are established and the down payment is made.
6. At the end of the leasing period, provided that the new company has made all lease payments on time, the ministry's right to recourse expires and full title to the ownership of the company passes to the employees free and clear.
    - Should the company fail to make the scheduled lease payments, the assets revert to the control of the sponsoring ministry.
7. There are no specific tax benefits provided for the employee purchase of the shares other than the specific provisions of the lease agreement.
8. Employees are not taxed upon the acquisition of the company, nor upon the shares allocated to their personal account, nor on the value of the shares during the period of their employment with the company.
9. An employee is taxed based on the value of the shares received when they leave the company.

Large Company Privatizations

10. Employees in larger enterprises subject to privatization are also given the option of acquiring up to a 20% stake in privatization transaction.
11. Under this scenario, employees are provided with a 50% discount on the share purchase price and are allowed to pay for their shares over time through payroll deductions.
    - The remainder of the shares are sold to strategic investors and/or to mutual funds that utilize vouchers issued to Polish citizens at large.

RUSSIA

Russia privatized approximately 12,000 medium and large-scale enterprises after 1992, with about two-thirds resulting in majority-ownership by their employees following privatization. Workers were given some shares for free and were provided significant purchase discounts. Managers were also allowed to purchase shares prior to any shares being sold to the public. Russian citizens at large were granted privatization vouchers to invest in privatizing companies and many employees used their vouchers to purchase additional shares in their own companies. Following the first round of privatization, however, the level of employee ownership fell precipitously as employees sold their shares to outside investors. Very few companies preserved broad-based employee ownership systems.

The Russian government subsequently approved a new law governing the establishment of People's Enterprises (PE), which are subject to the following rules:

1. Each PE must have at least 51 employees, and can have no more than 5,000 shareholders;
2. 75% or more of authorized capital must belong to the workers;
3. The worker-shareholder is required at termination of employment to sell his/her shares back to the enterprise, which is obligated to repurchase the shares at no less than 30 % of its net assets;
4. New hires are allocated with shares based on salary, not earlier than three months after rehire nor later than two years after employment in the PE;
5. General directors, their assistants, and members of the Supervisory Council and Control Commission of the PE may not purchase shares;
6. Decision-making in a PE is determined at the general shareholders meeting on the basis of one-man/one-vote, while solely economic questions are decided on the basis of one-share/one-vote;
    a. all shares must be voting shares;
    b. the posts of General Director (chosen at the general shareholder's meeting), and Chairman of the Supervisory Council can be the same person;
7. The number of non-shareholding employees of a PE may not exceed 10 % of the total number of employees in any given fiscal year;
8. In any given accounting year, the PE's General Director's salary is set at no more than 10 times the average wage in the firm;
9. No one worker can own shares which exceed a nominal cost of 5% of the PE's authorized capital;
10. A worker-shareholder has the right to sell up to 20% of his/her shares at negotiated value either to fellow worker-owners or back to the company, and then, as a last resort, to non-shareholding employees of the PE;
11. In cases of bankruptcy or default, as well as on other occasions as specified by law, a PE is subject to transformation into a joint stock company or an industrial cooperative society, and in a worst case, liquidation by judicial order.

SLOVENIA

Most of Slovenia's 2,000 state-owned enterprises have now been privatized with at least partial employee ownership. Management-employee buyouts are typically structured with the assistance of a holding company that acts as the seller.

1. Usually, the state company transfers assets into one or more new companies and becomes the holding company with 100% ownership of the subsidiaries.
2. 20% of the shares are distributed to employees at no charge;
3. 20% is distributed to investment funds owned by citizens at large;
4. 10% is contributed to the national pension fund;
5. 10% is contributed to the national compensation fund.
6. The remaining 40% is sold either to employee groups directly, or sold in a public tender or auction.
    a. If the stake is sold to insiders, employees can purchase shares at a 25% discount, with a 20% down payment. The remaining shares are bought at a fixed price indexed for inflation with the state providing financing over four years at a 2% interest rate. Company profits can be used to buy the shares.
    b. The state retains voting control of the shares not yet paid for.

SPAIN

Like in other European countries Spain has its regulations concerning profit sharing, share based profit sharing, and indirect financial participation via asset savings for pension funds. Typical for Spain is the regulations and commitment for the social economy. It is significant that the Spanish government considers its fiscal support for share-based profit-sharing as one of its measures favouring small- and medium-sized firms. In fact the development of firm's pension plans and the pronounced support for workers' co-operatives and labour firms should be looked at in a complementary manner as the main Spanish plans to improve worker's financial participation in the firm.

1. Shares given by the company, a parent company or other firm of a same group to the workers for free or at an price inferior to that in the market are excluded from workers' income tax assessments if:
    a. the value of the shares is not greater than 500,000 pesetas in a year or 1,000,000 in five years, and
    b. if the workers keep the shares for at least three years.
2. The offer must be part of the firm's general remuneration policy and must contribute to increase workers' participation on the firm
    a. it must be offered to all workers in the same conditions;
    b. the workers must not own already more than 5% of the firm.
3. When the firm and the workers are in compliance with the terms indicated above, shares given to workers will not be considered as payments in kind for purposes of taxation.
    a. in labour law terms they are payments in kind and therefore their value cannot amount to more of the 30% of the wage.
    b. payments in kind have an exceptional character and their establishment is only admissible if there is a law, a collective agreement or a pact between the parties authorising it; it can never be unilaterally imposed by the employer.
4. In Labour Cooperatives (Cooperativas de Trabajo Asociado) the distribution of profits between the workers depends on the work done individually.
    a. wages are an early participation on these profits and are not called wages but advanced results (anticipos societarios).
    b. 20% of the profits or cooperative returns and 50% of the extraordinary profits must be incorporated to a reserve fund that can never be distributed between the associates;
    c. a further 5% will go to a fund for training and the promotion of the social economy.
    d. the number of hours per year done by workers who are not associates cannot be more than 30% of the hours per year worked by the associates.
5. Employee buy-outs receive some financial support from the state. The condition is that there is no continuity with previous ownership, i.e. the employer cannot become an associate or shareholder in the newly formed firm.
6. Labour coops are "specially protected" by the law.

a. They receive exemptions from the capital transfer tax.

b. They only pay 10% as corporation tax (35% normally; 20% for other cooperatives) and have a 95% reduction on the tax over economic activities.

c. Further fiscal advantages come from the fact that they can consider as costs those funds constituted as a reserve to compensate future losses.

7. Labour firms (Sociedades Laborales) are firms in which at least 51% of the capital belongs to the workers.

    a. None of the associates may own more than one third of the capital (except for the possible participation of the Public Administration that can be up to a 50%).

    b. Participation in capital can be of two types:

        i. labour type, those shares in hands of permanent workers, and

        ii. general type as for the rest.

    c. The firms must constitute a Special Reserve Fund to which 10% of the profits will be incorporated annually.

    d. When selling labour type shares permanent workers who are not associates have preference over associated workers, general associates and temporary non-associated workers in that order.

8. Those labour firms that incorporate 25% of profits to the Special Reserve Fund in a given year may benefit from a 99% tax exemption from capital transfer tax.

Source: Erik Poutsma, Nijmegen Business School, Univ. of Nijmegen, The Netherlands, Delivered at the European Foundation for the Improvement of Living and Working Conditions, 2000

TRINIDAD & TOBAGO

Employee ownership plans in Trinidad & Tobago are established under the country's Employee Profit Sharing Plan rules. Plans are approved by the Board of Inland Revenue and are considered profit sharing plans, rather than employee ownership plans.

1. The company agrees to make the plan a permanent distribution of annual profits to employees in the form of a bonus.
2. The plan is governed by a trustee with fiduciary responsibility to the participants.
    a. The trustee must be a corporation or a group of not fewer than three individuals.
    b. At least one of the trustees shall be an employee elected by other employees.
3. Not less than 40% of the annual bonus transferred to a Profit Sharing Trust is used to buy employer shares. The remainder, if any, can be used for cash contributions to employees.
4. The annual bonus distribution may not discriminate in favor of any employee or class of employees. Distributions can be made on the basis of relative annual pay.
5. Income of the trust and distributions to employee accounts are not currently taxable to the employees, but are tax-deductible to the employer.
6. Shares are allocated to employees according to plan rules each year. Each employee receives an annual statement indicating the number of shares in their account and their value.
7. Five years after shares have been allocated they can be transferred to the employee. If the employee dies, retires, or has employment terminated, the shares can be transferred at that point if earlier than five years.
8. If shares are transferred to the employee at employment termination or while still employed, they are taxed at 5% up to the first $5,000, 15% for the next $5,000, 20% for the next $5,000 after that, and 25% for any remaining shares.
9. If the employees dies, retires, or is permanently disabled, there is no tax on the shares.

Source: National Center for Employee Ownership (US) *www.nceoglobal.org*

UNITED KINGDOM

In the United Kingdom five distinct schemes of ESOPs are covered by statute law. Each of these schemes may qualify for tax relief. A company is free to introduce schemes of all five kinds concurrently:

Profit-sharing schemes

1. With Profit-sharing schemes the company may apply pretax profits to buy shares for employees up to specified limits, which are linked to payroll and which may—but need not—require a matching share purchase by the individual employees.
    a. The latter is the so-called buy-one-get-one-free variant of the straight profit-sharing schemes.
    b. The matching "purchased" shares may be paid for by individual employees, pretax.
    c. Both the "free" and the tax-assisted employee purchased shares become free of any income tax liability for their employee owners at the conclusion of a three-year retention period.
    d. To be approved these schemes must have "all-employee" coverage, and the distribution of shares among employees must be objective and satisfy a fairness test.

Save-as-You-Earn (SAYE) Schemes

2. Under SAYE schemes, it is the employees' earnings rather than the company's profits that finance the whole of the employee share acquisition.
    a. Employees who choose to take advantage of SAYE schemes commit themselves to set aside from post-tax pay fixed sums each month—within defined top and bottom limits.
    b. These moneys are then held in interest-yielding accounts with third parties—approved banks or building societies—for a minimum of five years.
    c. The interest income, which is tax exempt, is added to the principle.
    d. At the end of five years the employee may withdraw (with no tax liability) what has been accumulated in the interest-bearing account and then either apply the money to buy shares in the employing company at the price that prevailed when the original SAYE commitment was entered into, or use it in any other way.
    e. Despite their name, SAYE schemes in the United Kingdom are also all-employee share option schemes—with the ability to opt out if the share price is no higher when the savings commitment ended than when it started.

Company Share Option Schemes

3. With Share Option Schemes there is no requirement on the employee to make regular or any savings, and no all-employee coverage is required.
    a. Management is in principle free to invite employees to take part in these schemes—or not—with unfettered discretion.

b. There is a relief from capital gains and income tax which might otherwise be payable when the option is exercised.
c. The starting value of the shares over which an employee may be granted a "Company" scheme option may not exceed £30,000, or roughly twice the current average annual pretax pay in the United Kingdom.

Statutory ESOPs

4. Statutory ESOPs are also sometimes known as a Statutory Employee Share Ownership Trusts.
    a. The ESOP trust may borrow money to finance the purchase of shares for employees;
    b. The company may make payments to the trust out of pretax profits to enable the latter to pay back its borrowings including the principle as well as interest.
    c. As with the profit sharing schemes, there is an all-employee coverage requirement, and the distribution of shares between individual employees must be objective and such as to satisfy a fairness test.
    d. All the shares in a statutory ESOP must eventually be distributed to individual employees, though the law allows this to happen over up to 20 years.
    e. For maximum tax effectiveness statutory ESOPs are normally operated in conjunction with Profit Sharing Schemes and sometimes with SAYE schemes as well.
    f. Corporate tax deductions are permitted for principal and interest payments on ESOP loans;
    g. Selling shareholders may qualify for a deferral of capital gains taxes for sales of stock to ESOPs in privately-held companies if the ESOP owns a minimum of 10% of the company stock.

All-Employee Share Ownership Plans

5. AESOPs permit companies to choose between a flexible combination of three modules – free shares, partnership shares and matching shares.
    a. Companies must offer all employees the opportunity to participate in the plan whether they work full or part time.
    b. Where an employee leaves the company, their shares must be transferred to them. A tax charge may then arise.
    c. Free shares
        i. Employers can give up to £3,000 worth of free shares per annum to employees free of income tax and National Insurance (NICs).
        ii. Up to 80% of the shares awarded can be linked to performance. The highest performance award to any employee cannot be more than four times greater than the highest award made to an employee on the "similar terms" basis.
        iii. All shares may be awarded by reference to performance as long as awards made to the employees in each performance unit are made on similar terms to the other employees in that unit.
        iv. Shares may be subject to a holding period of 3-5 years.

        Taxation:

v. If the employee withdraws the shares within three years of the date of the award, he/she will have to pay income tax and NICs on the market value of the shares at the date of leaving.

vi. If the shares are held 3-5 years from the date of the award the employee will have to pay income tax and NICs on the lesser of the market value of the shares when they were first awarded and the market value of the shares on the date of leaving.

vii. After 5 years employees become entitled to shares unconditionally at the end of the holding period. They can choose to leave them in the plan or take them out and hold them elsewhere or sell them.

viii. No Capital Gains Tax is payable when shares are taken out of the plan.

d. Partnership Shares

i. Employees can buy shares from their pre-tax weekly or monthly salary subject to a limit of the lower of £1500 per annum or 10% of salary. These shares are free of income tax and NICs.

ii. Shares can be accumulated for a period up to 12 months, the 'accumulation period', with shares having to be bought within 30 days of the end of the period (the price used will be the lower of the market value at the beginning or end of the accumulation period); or

iii. The purchase of the shares may be made out of deductions from employee's pay (usually weekly or monthly) - shares must be bought within 30 days of deduction from pay.

Taxation:

iv. Employee allocations of pre-tax salary to the purchase of partnership shares will not affect their ability to contribute to retirement benefit schemes, retirement annuity schemes and personal pension plans.

v. Employees who withdraw partnership shares from a plan before they have been held in the plan for five years may have to pay tax and NICs in respect of those shares. The amount of any income tax charge will reduce the longer the partnership shares are held in the plan:

vi. Where the partnership shares have been held in the plan for less than three years, employees will pay income tax and NICs on an amount equal to the market value of the partnership shares at the time they are removed from the plan;

vii. Where the partnership shares have been held in the plan for at least three years but less than five years, employees will pay income tax and NICs on the lesser of the salary used to buy the shares and the market value of the shares at the time they are removed from the plan.

viii. After 5 years employees will be able to remove the shares from a plan at any time without paying income tax.

ix. The treatment of partnership shares with respect to CGT is the same as free shares.

e. Matching shares

1. Employers can give employees up to two free shares for each partnership share the employee buys.

2. Shares may be subject to a holding period of 3-5 years
3. The income tax and CGT treatment of matching shares for employees is the same as for free shares.

Tax Treatment for Employers

6. Corporate Tax Relief – Employers qualify for tax deductions for:
   a. The costs of setting up and administering the plan;
   b. The gross salary allocated by employees to buy partnership shares;
   c. The costs they incur in providing shares for employees to buy to the extent such costs exceed the employees' contributions;
   d. The market value of free and matching shares at the time they have been acquired by the trustees. The deduction is given in the accounting period when the shares are appropriated to the employees.
   e. Trustees may borrow money in order to acquire shares in the employing company. Where this happens and the company meets the trustees' costs, it may deduct any payment of interest made by the trustees, in computing its corporation tax profits.
   f. Free and matching shares acquired from another trust are deductible to the extent that no corporation tax deduction has already been given for the acquisition of those shares by the other trust.
   g. An employer will have to operate PAYE and account for NICs where an income tax charge arises under the terms of the plan and the plan shares can be readily converted into cash.
7. Tax Treatment for Trustees
   a. There is no charge to income tax on any dividends arising on unallocated shares held in the plan provided the shares are awarded to employees under the terms of the plan within two years of their acquisition.
   b. If the shares are not capable of being readily converted into cash this period is extended to five years after their date of acquisition, or within two years of the date on which they become convertible if that is earlier.
   c. For these purposes forfeited shares are treated as being acquired by the trustees on the date that they are forfeited.
   d. Provided shares are awarded to employees as described above, the trustees will not have any CGT on the disposal of the shares to employees.
   e. Shares held in a qualifying employee share ownership trust (QUEST) on Budget Day (21st March 2000) can be transferred to a new plan trust without losing the corporation tax relief already given on the contribution made to the QUEST to buy the shares.
8. Dividends
   a. Dividends paid out to employees are taxable in the normal way;
   b. Dividends paid in respect of shares in a plan to be reinvestment in 'dividend shares' are exempt from tax within specified limits (up to £1,500 per year); any balance is paid to the employee and taxed in the normal way.
   c. The dividends received by trustees must be reinvested in plan shares on behalf of employees within 30 days of the time at which dividends become payable.
   d. Dividend shares are subject to a holding period of three years during which employees will not be permitted to sell them, unless they leave the relevant

employment. Where employees leave the relevant employment during the holding period their dividend shares will be transferred out of the plan and income tax will be payable on the original dividend as if it had been received in the normal way but in the year employment ceased.

e. Once the three-year holding period has expired the dividend shares can be withdrawn tax free, and if they are sold immediately there will be no CGT. Alternatively, these can be held in the plan until the participant's employment ceases.

Source: ProShare: http://www.proshare.org/eso/Approved.asp

UNITED STATES

Today in the United States upwards of 15,000 companies have some amount of broad-based employee ownership. The aggregate value of employee holdings is estimated to be in the range of approximately seven percent of the market capitalization of U.S. companies. The most typical form of employee ownership is an ESOP, but a variety of other mechanisms, such as retirement plan investments in employer securities, stock purchase plans, stock bonuses and stock options made available to a broad cross-section of employees, are frequently used. A growing number of multinational companies are now beginning to offer shares to their international employees as well.

1. Non-Leveraged ESOPs
    a. Trust funds established by sponsoring corporations for the benefit of employees
    b. Corporate sponsor qualifies for tax deductions of cash or stock to the plan, subject to maximum limits of 25% of payroll
    c. Contribution must be non-discriminatory to ensure broad-based participation by all eligible employees
    d. Assets of ESOP trust must be “primarily” invested in stock of sponsoring company
    e. Stock must be valued at least annually by independent appraiser
    f. Shares and/or cash held in individual employee accounts within the trust
    g. Shares held in ESOP trust are exempt from taxation. Taxes paid by employee upon distribution based on the value of assets distributed from plan.
    h. Employees eligible to diversify 25% of stock account balance upon attaining age 55 with 10 years of participation in the plan
    i. Shares distributed to employee at break in service or retirement, death, disability
        i. May be paid in lump sum or in installment payments
        ii. Distribution may be deferred for pre-retirees for up to 5 years and paid out over a maximum of 5 additional years in equal annual installments
        iii. Closely-held companies required to purchase shares back from departing employees
2. Leveraged ESOPs
    a. Subject to ESOP rules above, but a leveraged ESOP uses borrowed funds to acquire stock for employees
    b. ESOP loan is guaranteed by the sponsoring corporation
    c. Debt is repaid out of future company earnings.
    d. Stock is allocated to employee accounts as the loan is repaid
    e. Corporation qualifies for a tax deduction for both principal and interest payments on the loan
    f. Leveraged ESOPs commonly used to buy out departing owners in closely-held businesses, to divest divisions from larger companies and, more rarely, to finance employee buyouts.
3. Special ESOP Tax Incentives

   a. Tax deduction for all corporate contributions to the plan up to 25% of payroll per year
   b. Taxes on plan assets, including any appreciation in value, deferred until assets paid to departed employee
   c. Dividends paid to ESOPs are tax-deductible to the sponsoring corporation
   d. Selling shareholders in closely-held companies may defer capital gains taxes on sales of stock to the ESOP if:
      i. The shareholder(s) have held their shares for at least three years
      ii. The shares were not acquired through a compensatory benefit plan
      iii. After the sale the ESOP owns a minimum of 30% of the company
      iv. The shareholder reinvests the proceeds of the sale within one year in stocks and bonds of U.S. operating companies.

4. S Corporation ESOPs
   a. Shareholders of corporations registered under Subchapter S of the US Code are taxed at the individual tax rate rather than the corporate tax rate
   b. ESOPs in S Corporations generally follow the above-referenced rules for ESOPs with two main exceptions:
      i. S Corporation ESOPs are exempt from federal taxation as an S Corporation shareholder
      ii. S Corporation ESOPs do not qualify for the dividend deduction and the tax deferral for selling shareholders referenced in 3c and 3d above.

5. 401(k) Plans – These are tax-deferred savings plans which are commonly used to hold employer stock as well as other diversified investments.
   a. Employee may elect to defer salary into a 401(k) savings plan
   b. Deferred amounts are exempt from taxation until withdrawn from the plan
   c. Companies commonly provide a match on employee deferrals, and this match is often made in the form of company stock
   d. Employees may also elect to invest some of their savings deferral into company stock funds, though securities regulations must be followed for employee investments

6. Stock Options – There are two types of stock options under U.S. law
   a. Incentive Stock Options (ISOs)
      i. may only be issued to employees;
      ii. option price cannot be less than 100% of fair market value at exercise;
      iii. option term cannot be more than 10 years;
      iv. the value of the options that first become exercisable by any one individual in one year is limited to $100,000 measured at the date of grant;
      v. income from ISOs may be subject to Alternative Minimum Tax (AMT);
      vi. to qualify for capital gains tax rate, employees must hold ISOs for at least two years from the date of the initial grant and must hold the stock for at least one year after exercise;
      vii. employee not taxed at exercise, but when the shares are sold;

viii. at sale, employee taxed at long term capital gains rate on the difference between the price of the option at the time of grant and the value of the shares when sold;
ix. Corporation receives no tax deduction if employee meets ISO holding requirements.

b. Non-Qualified Stock Options (NSOs)
   i. not subject to ISO restrictions referenced above;
   ii. employee is taxed at ordinary income tax rates upon exercise of the option;
   iii. tax due at exercise is the difference between the grant price of the option and the price at the time of exercise;
   iv. corporation qualifies for a corresponding tax deduction equal to the employee's tax liability;
   v. if shares are held post-exercise, any subsequent appreciation in value is taxed at capital gains rates.

7. Employee Stock Purchase Plans
   a. allows employees to purchase stock with salary deferrals
   b. tax rules are similar to those of incentive stock options
   c. cash deferrals held by trustee until end of option period (6-24 months)
   d. company may discount the share price up to 15%
   e. companies commonly allow stock purchases to be made at the lower of the stock price at the beginning or the end of the purchase period
   f. must be available to all employees
   g. employees owning 5% or more of company stock are ineligible to participate.