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Increasing Margins

ESOPs: The Misunderstood Tool of Ownership Transfer

by Mike Hall

While developing ownership-transfer plans for the past 17 years, I avoided Employee Stock Ownership Plans (ESOPs) entirely for the first 10 years. They were generally regarded as too complicated and too expensive. Even now, I am hesitant to ask my A/E firm clients to consider an ESOP as part of their ownership-transfer plan. Every client seems to have a story about a failed "ESOP firm." Suggesting that a firm even consider an ESOP is a sure way to be labeled a quack in about half the firms I have worked with.

But, in truth, an ESOP is simply another financial tool. Like any tool, it can be used or abused. This report will demonstrate how ESOPs work and how to use them properly in the ownership transfer of a professional design firm.

An ESOP is, above all, an effective tool to avoid taxes in an ownership transfer. "What taxes? I have never paid corporate taxes in the entire life of my company. Why should I go to any special effort to avoid taxes?" observed a participant at a seminar I gave on ownership transfer. Most firms can and will avoid all corporate taxation until they transfer their ownership. At that point, taxation will occur at two levels:

- If your firm pays bonuses, employees pay income tax on the bonuses and are able to invest only the after-tax amount in your company's ownership. With an ESOP, taxation on contributions is deferred until an employee retires. As such, the entire amount put into an ESOP is available for investment in your company's ownership.

- If you sell your ownership directly to employees, you will have to pay capital gains tax on this transaction. However, if you sell your ownership to an ESOP, you can defer taxation on the sale, provided you invest the proceeds of the sale in marketable securities. As such, you avoid a second level of taxation and can continue to grow your investment pre-tax until you need to spend the money.

In sum, ownership transfer without an ESOP will result in two levels of taxation on every dollar used in ownership transfer. The employees pay ordinary income tax (35% or so) and the existing owners pay capital gains tax (20%). The IRS gets 48% of every dollar used to transfer ownership and you get 52%. The situation becomes worse if you have to pay state income tax.

The impact of taxation is almost the same if the corporation retains the earnings and purchases the ownership from the existing owners. C-corporations pay a flat 34% tax on retained cash and Sub S-corporations pass through the taxation on retained cash to shareholders, often at a rate of 39%. Again, the existing owner will also pay capital gains tax.

Ownership transfer with an ESOP is tax-deferred at both of these same levels. A dollar of

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earnings can be a dollar in your pocket as a selling owner. No other approach to ownership transfer can avoid taxes like an ESOP.

ESOP defined, warts and all. Simply put, an ESOP is almost the same device as a qualified profit-sharing plan or 401(k). About 90% of the tax code that defines how an ESOP works is the same law that defines a profit-sharing plan. The essential difference is that money contributed to a profit-sharing plan typically is invested in mutual funds. With an ESOP, contributions are invested in your company's own stock. Contributions to the plan are deductible by the company, but are tax-deferred to the employees. They are allocated to employee retirement accounts pro-rata to their compensation, just like a contribution to a profit-sharing plan.

The number one problem with an ESOP is that it distributes ownership too broadly. The key employees who will lead the firm into the next generation will not have enough ownership if their entire ownership position comes through the ESOP. An ESOP, if overused, can stifle a firm's entrepreneurial culture.

The solution to this problem is moderation. Don't rely too heavily on an ESOP in the ownership transfer process. An ESOP is a tool. It is not a total ownership transfer planning solution. The cornerstone of every ownership transfer plan, in my experience, is the direct sale of ownership to key employees. An ESOP is an additional feature to this basic approach that speeds the process and saves a lot of taxes. I recommend that firms limit their ESOP ownership to 50% or less of the firm. Overuse of an ESOP is abuse of the tool.

A real-life example. A firm that had tried and failed to develop an internal ownership plan based entirely on the direct sale of ownership to key employees once approached me. The problem was that the 80% owner wanted to retire in just five years. The key employees were unwilling to assume the risk connected with a large sale of stock to the firm. Although the owner was willing to finance this transaction, the loan would have required repayment with after-tax earnings. Even with the firm valued at book value, this was too much risk.

The principals asked me to find a buyer for their business. They had more than five years of steady growth and 15% or so pre-distribution profits. I lined up three buyers. The best of the bunch offered 1.25 times the book value. The agreement was drafted, but two days before it was to be signed, the major owner got cold feet. "The value is just too low!" he complained.

I encouraged him to consider an ownership transfer plan with an ESOP. I developed and presented a plan that included the direct sale of ownership to key employees, plus an ESOP that would grow to 50% of the firm's total ownership. The value of the firm was 1.35 times book value and the entire sale was tax-deferred to the major owner.

The key employees eagerly endorsed the plan; they became major owners without taking on personal financial risk. And they were much better off, both personally and financially, than they would have been with the sale of the business. Today, two years later, the plan is working. The first 30% is paid in full and the transfer of management responsibilities is well underway.

This plan would not have worked without the ESOP. Time was too short. Because taxes were deferred on half the sale, the firm could afford to pay 35% more than book value and still use less earnings than paying only book value for the business on an after-tax basis.

Conclusion. As often as not, a firm will choose not to carry out an ESOP because of a remote fear based on something a peer or colleague may have said about it. Everyone seems to know of a firm that had an ESOP and failed, however. They seldom know much at all about what happened, or why.

An ESOP is a tool. It cannot save a firm that is failing and it will not cause a healthy firm to fail. Used properly, it can speed the process of ownership transfer, save a lot of taxes, and increase the wealth of everyone involved in the process. Used incorrectly, it can create problems.

Examples of firms that have used an ESOP incorrectly should not deter other firms from

considering an ESOP as part of their ownership transfer plan. A hammer, if used incorrectly, can cause more damage than good. However, this is not a valid argument against the hammer.

Finally, there is the argument that ESOPs are complicated and expensive. An ESOP is about 50% more complicated than a 401(k) and, as such, it costs about 50% more than a 401(k) to administer each year. In addition, a firm with an ESOP must get an annual independent valuation.

Look at it this way: A firm that is worth $1 million and has an ESOP that owns 50% of the ownership will save about $250,000 in taxes every 15 years because of the ESOP ($1,000,000 x 50% ESOP x 50% tax rate). Fifteen years is the typical horizon for a firm ownership turnover. A firm that is valued at $1 million will save about $16,666 a year in taxes by using an ESOP ($250,000 ÷ 15 years). I estimate annual valuation and administration expenses at about half this amount.

An ESOP is not for every firm. More than half of the ownership transfer plans I develop do not include an ESOP. At a minimum, I present my clients with two ownership transfer plans, one with an ESOP and one without. Most of the time I can demonstrate that everyone is wealthier if an ESOP is used properly. "Everyone" includes the seller, the key employees who also purchase direct ownership, and the employees who own a portion of the firm only through participation in the ESOP.

So when determining whether an ESOP should be a part of your ownership transfer plan, be certain to understand what this tool can do if used properly.

Mike Hall is founder and president of Hall & Co. (Poulsbo, Wash.; 360-598-5011; www.Aejob.com), a management consulting firm specializing in the A/E professions. Hall has prepared ownership transfer plans for more than 100 architectural and engineering firms.