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# The ABCs of ESOPs

By Daniel Rome Levine

**EMPLOYEE STOCK OWNERSHIP PLANS  
ARE MAKING  
OWNERSHIP SUCCESSION  
A SUCCESS**

**F**inancial consultant Colvin T. Matheson stood before a standing room only audience at the ACEC Fall Conference in Portland, Maine, last September, to deliver a presentation on Employee Stock Ownership Plans, or ESOPs, as they are commonly called. Matheson was not surprised by the turnout. An increasing number of engineering firms are adopting ESOPs because of their many benefits. “We’re seeing a resurgence in them,” says Matheson, managing director of Matheson Financial Advisors in Falls Church, Va. “There’s a growing trend.”

“You have to sell the value of the program so that they appreciate what the benefit is to them. Most successful ESOP companies have tremendous employee communication plans.”

—ERIC FLICKER  
PENNONI ASSOCIATES



An ESOP is a tax-qualified retirement plan that invests primarily in the stock of a company. The underlying theory is that by providing employees—from mail sorters to top managers—with stock it will lead to a greater personal stake in the company's success and, therefore, increased productivity. “I call it capitalistic socialism,” says Matheson.

And there's evidence that these plans work. The Washington, D.C.-based ESOP Association, the trade group for companies with employee stock ownership plans, released a report last August showing that 88 percent of member companies surveyed said creating an ESOP was “a good decision that has helped the company.” In another survey, conducted in 2000, 75 percent of member companies reported their ESOP improved employee motivation and productivity.

The ESOP Association says there are more than 10,000

companies in the U.S. with employee-owned stock plans. Most are privately held. About 8 percent are professional firms, says the association, which would include engineering companies.

Besides empowering employees, one of the main reasons companies form ESOPs is to take advantage of generous tax breaks created by Congress to spur employee ownership. Large shareholders and owners of private companies often turn to ESOPs when planning for retirement and succession. An ESOP allows them to free up their illiquid company stock without triggering capital gains taxes, and preserves the company's independence by keeping it in the hands of valued colleagues and employees.

### Engineering ESOPs

Engineering firms have unique characteristics that make them especially well-suited for employee ownership, says James G. Steiker, president and founder of Philadelphia-based SES Advisors, Inc., which provides consulting services for ESOPs. Engineering firms, he says, are not typical takeover targets. “More than most businesses, the natural buyers are the key engineers in a firm,” Steiker says. “Many firms have a history, a culture of broad [employee] stock ownership. So, in dealing with liquidity and succession, it becomes a natural idea that employees should come to own the firm. It fits both the culture and purpose of engineering firms.”

Steiker says the “tremendous tax advantages” offered by ESOPs make them a tool to consider for any owner or major shareholder of an engineering

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MATHESON FINANCIAL ADVISORS



firm who is considering selling the business.

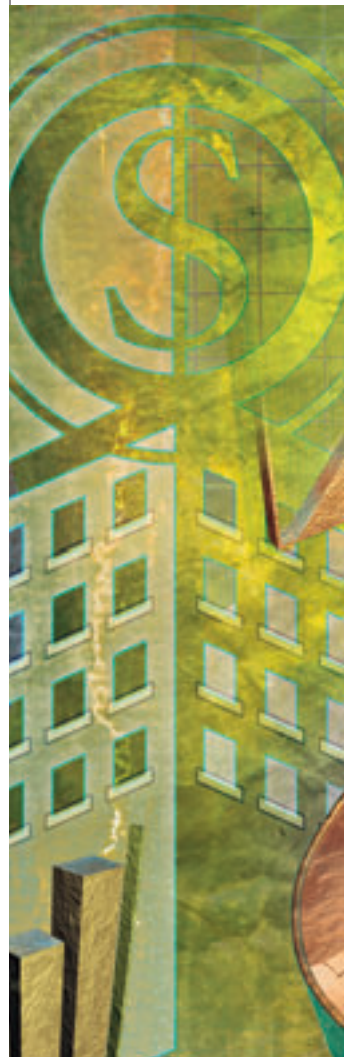
In a typical non-ESOP sale within a company, bonuses are paid to key managers, who, in turn, use that money to purchase stock from the company's founder or major shareholder. Steiker calls these transactions “tax disasters” because the bonus received by the managers is taxed at a 40 percent effective federal and state combined marginal tax rate. And when they buy the founder's shares, he or she gets hit with a 15 percent federal capital gains tax, plus local taxes. “The result,” says Steiker, “is the government has essentially been made a more than 50 percent partner in the cash flow of the firm.”

One firm that has benefited from the implementation of an ESOP is Pennoni Associates, a multi-disciplined consulting engineering firm with 550 employees in Philadelphia. In the early 1990s, founder Chuck Pennoni was in his late 50s when he started thinking about retirement. He formed a committee of employees and asked them to study ownership transition options. Pennoni strongly believed that professional services firms should be owned by employees who are actually doing the work and not by out-of-town, independent investors.

The committee investigated

numerous possibilities and concluded that a so-called leveraged ESOP made the most sense. In 1994, a leveraged ESOP was put in place and the company borrowed enough to purchase 30 percent of Pennoni's shares. By 2003, the firm had doubled in size and, with the help of another bank loan, was able to purchase another 30 percent of the founder's shares.

Eric Flicker, Pennoni Associates' chief financial officer and a former ACEC chairman, says explaining the program to employees is a key to achieving success in an ESOP. Flicker says that since employees do not



contribute any money to ESOPs they may not automatically realize the value and benefit of the program.

"You have to communicate, communicate, communicate to get people to accept the fact that they are employee owners," Flicker says. "You have to sell the value of the program so that they appreciate what the benefit is to them. Most successful ESOP companies have tremendous employee communication plans."

### The Tax Benefits

Unlike other qualified retirement plans, like 401Ks, ESOPs are permitted by law to borrow money to purchase company stock. These leveraged ESOPs are the most commonly used. First, the company establishes a trust, which is overseen by major stockholders or an outside financial professional. The company then borrows from a bank or other qualified lender to fund the purchase of the shares from the owner, or majority shareholder. The money is then re-loaned to the ESOP trust, which uses it to buy the shares. Upon purchase, these shares are held by the trust in what is known as a suspense account.

Once a year, typically, the company makes an ESOP contribution to the trust. At the same time, shares are released from the suspense account and given to employees based on a formula determined by each company. The net result of a series of financial transfers among the company, the trust and the bank is that the company's contributions to the ESOP trust, which typically equal its interest and principal on its bank loan, are fully tax deductible as a business compensation expense.

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SES ADVISORS, INC.



There is an added tax advantage to the owner or major shareholder of a private subchapter C corporation that uses an ESOP. If they sell a minimum of 30 percent of their shares to the ESOP trust and invest the proceeds in stocks or bonds of publicly traded U.S. companies within one year, they are able to defer all capital gains taxes on the sale. Capital gains taxes can be deferred permanently if the stocks or bonds pass to the shareholders' heirs upon their death, says Lowell Getz, a Houston-based independent financial consultant to engineering and architectural firms and an ESOP specialist.

When the tax advantages of ESOPs were created by Congress in the early 1970s as a way to encourage employee ownership, they were made available only to C corporations. But changes to the Internal Revenue

Code made S corporations eligible participants starting in 1998. (C corporations are general for-profit entities that are incorporated on the state level and pay income tax on taxable income generated by the corporation; S corporations are formed the same way but are taxed as a partnership or sole proprietorship rather than as a separate entity.) One major difference in ESOP rules between S and C corporations is that S corporations cannot take advantage of the capital gains tax deferral available to corporations with C status.

Otherwise, S corporations enjoy ample tax benefits. Among them, an S corporation's profits are totally tax-free when it has an ESOP that owns 100 percent of the company stock. Last October, President Bush

signed into law a tax bill that benefited S corporation ESOPs. The new law makes it possible for S corporations to use ESOP shares that have been allocated to employees to repay a plan loan, just as C corporations have long been allowed to do.

No doubt, understanding the intricacies of an ESOP can be a challenge. But those who work in engineering firms have an advantage, according to Getz.

"ESOPs are not easy for the rank and file worker to understand," he says. "They require a certain level of knowledge of finance and taxes and what the firm is doing with its money. In engineering firms, you're dealing with an educated work force that can better understand an ESOP than people at another type of company." ■

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