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**The straight scoop on ESOPs**

Why is this employee benefit plan so popular in the engineering industry?

BY IAN RUSK

Employee Stock Ownership Plans (ESOPs) are nothing new in the engineering industry. ESOPs have been around in one form or another since 1974 when provisions to the Employee Retirement Income Security Act allowed for retirement plans that invested in employers' stock. However, it wasn't until the mid-1980s that ESOPs really became popular. At this time, newly created tax incentives made these plans financially effective, particularly as a structure for leveraged buy-outs.

Over the years, various legislative changes have made ESOPs even more attractive and available to more companies.

In 1998, S-corporations became eligible to sponsor ESOP plans, and other recent legislation has resulted in increased limitations for annual ESOP contributions.

How ESOPs work

An ESOP is actually a defined contribution employee benefit plan, similar in many respects to a 401(k) plan, but designed to invest primarily in the sponsoring company's stock. The employees are not technically shareholders, but are beneficial interest holders in a trust established to hold the ESOP shares.

Once the ESOP trust is created, it may acquire shares in two ways. It may borrow money to buy shares (commonly referred to as a leveraged ESOP), or it may use cash contributed by the company to buy shares (a pre-funded ESOP). In either case, firms considering an ESOP need to analyze carefully their ability to cover the debt service on the ESOP loan or to fund cash contributions sufficient to purchase the required block of stock. Consideration must be given to the profitability and cash flow of the company, as well as its eligible payroll and the contribution limitations that will apply.

The shares owned by the ESOP trust are allocated to employees of the company based on some non-discriminatory means, such as their compensation as a percentage of overall eligible payroll, years of service, or some combination thereof. The company may also establish a vesting period for plan participants. With leveraged ESOPs, the shares are held in suspense and gradually released to participants as the loan is repaid.

The financial value of ESOPs lies with their tax advantages, which are three-fold.

When shares are sold to the ESOP, the selling shareholder, under certain circumstances, can defer the capital gains tax on the sale by rolling over the proceeds into a portfolio of qualified securities (referred to as qualified replacement property). This tax deferral, known as a section 1042 rollover, applies only to C-corporations where the ESOP ends up owning a 30- percent or greater ownership interest. As it is often the case that the selling owner has zero basis in their stock, this ability to defer capital gains tax is an attractive option.

The second and perhaps greatest tax benefit of the ESOP is the ability of the sponsor company to use pre-tax dollars to fund stock redemptions. Using an example of a leveraged ESOP, after the transaction of stock has occurred, the ESOP needs cash with which to pay the debt service (principal and interest) on the ESOP loan.

To fund the debt service, the company makes cash “contributions” to the ESOP, which are in turn used to make the ESOP loan payments. These contributions are a tax deductible expense for the company.

Finally, the ESOP is a tax-deferred benefit plan for the employee participants, and unlike many 401(k) plans, it requires no cash contributions on the part of the employee.

ESOPs in the engineering industry

Some of the earliest adopters of ESOPs include engineering and construction firms such as Parsons Corporation, Pasadena, Calif. ESOP companies in the industry now number in the thousands by some estimates. Among the 100 largest firms in the United States that are 50 percent or more employee-owned (as compiled and reported by the National Center for Employee Ownership, Oakland, Calif.), there were 20 firms in the engineering and construction industry.

These included such companies as the aforementioned Parsons Corporation; HDR, Inc., Omaha, Neb.; HNTB, Kansas City; Gensler, San Francisco; Burns & McDonnell, Kansas City; Weston Solutions, West Chester, Pa.; Kleinfelder, Walnut Creek, Calif.; CH2M Hill, Inc., Denver; STV Group, New York; Terracon, Lenexa, Kan.; and Brown and Caldwell, Concord, Calif.

At ZweigWhite, our research, as well as anecdotal experience, indicates significant growth in ESOPs as a form of ownership in the industry. This trend is being driven by many of the same factors that are driving growth in merger and acquisitions in the industry. The engineering industry is highly fragmented and made up of mostly small, privately held firms. In many cases, these firms are in their first generation of ownership, and the stock is still concentrated in the hands of the founders. Many of these owners are “baby boomers” who, as they near retirement, must begin to think about their exit strategies from their companies and how they can recapture the equity in their companies. In these situations, ESOPs can be very attractive vehicles for managing a major stock redemption in light of the tax advantages previously described.

What makes a successful ESOP firm? One of the potential problems with ESOPs results from their nature as a broad-based employee benefit plan.

Whatever allocation method is chosen by the company, the ESOP accounts of top managers will not be substantially larger than those of the average employee.

Because of this, a firm that is majority or entirely ESOP-owned runs the risk of becoming a company in which nobody feels they have a substantial vested interest.

To make matters worse, the next generation of management is then burdened with the responsibility of managing the ESOP and all its ongoing redemption liabilities.

However, many ESOP companies in the engineering industry have chosen to limit the ESOP to an ownership level that is sufficient to take full advantage of tax benefits (specifically the aforementioned 1042 rollover benefit), while reserving a block of stock outside of the ESOP for direct ownership by top management. In this scenario, all employees have some level of ownership through the ESOP, while the firm's key staff may have additional ownership outside of the ESOP that is sufficient for them to feel truly vested in the longterm performance of the company. In addition, because the ESOP ownership level is held to a manageable level — often between 30 percent and 50 percent — the ESOP stock redemption liability is less burdensome to manage. This is a formula that has proven successful for many engineering firms.

Another important success variable is communication to and education of the staff about the benefits of the ESOP. This is critical particularly when the ESOP is first implemented. It's not unusual for employees in these situations to be cynical and suspicious about management's intentions.

Open and honest communication with regard to the reasons management has elected to implement an ESOP, the advantages of the ESOP structure, and the benefits to all parties goes a long way to making the ESOP a success. And of course, ESOPs are best received by employees when they are not instituted at the expense of other employee benefit plans, but instead as an additional benefit plan and a way for the employee to further diversify their retirement assets.

New trends in ESOPs

An emerging trend in ESOP structure has been the increased popularity of the Scorporation ESOP. While S-corporation owners may not take advantage of the previously described 1042 rollover benefit when they sell stock to an ESOP, the passthrough tax structure of an S-corporation provides its own compelling advantage.

Because the ESOP is a tax-exempt shareholder, a 100-percent ESOP-owned Scorporation has no income tax obligations.

S-distributions that normally would need to be made to cover the individual shareholders' tax liabilities now can be reinvested in the company instead. This creates a tremendous cash flow benefit for firms operating under this ownership structure.

The additional cash flow may be used to fuel growth and can allow the firm to provide other benefits and incentives to key staff as compensation for the lack of significant ownership stakes.

Conclusion

ESOPs are certainly not for every firm.

To begin with, the cost and administrative burden of an ESOP often make them impractical for very small firms.

Additionally, there are the issues of cultural fit and whether the organization is ready to embrace the participative management philosophy that goes hand-in-hand with ESOPs.

If deployed thoughtfully, however, ESOPs can be a powerful solution to an ownership dilemma, providing significant tax and cash flow benefits to sellers, employees, and the company itself. With so many of the largest firms in the engineering industry already operating under full or partial ESOP ownership, and a huge number of engineering firm owners nearing retirement, we expect to see continued growth of this ownership structure during the next 10 years.

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