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ESOPs bring tax, productivity benefits

Business First of Columbus - by Tami Kamin-Meyer For Business First

When Ohio Transmission Corp. established its employee stock ownership plan in 1975, the intent was fairly simple – give employees a stake in the company.

These days CEO Philip Derrow thinks the plan is more a “cultural element” of the business than an incentive.

“When employees share part of the company, making them owners of the company, they become part of the management style. So, employees are more a part of the decision-making team rather than just worker bees,” he said.

Derrow attributes the comfortable, open-management style of the company – a distributor of industrial pumps and power transmission equipment – to the ESOP’s presence. The business has 307 employees.

Derrow’s firm isn’t alone. Ohio is home to about 400 companies offering upwards of 45,000 employees some form of stock ownership plan, said Tim Jochim, a partner with the law firm of Kegler Brown Hill & Ritter Co. Nationally, estimates have between 10,000 and 11,500 businesses nationwide offering an ESOP to their employees. The Buckeye State also is home to the country’s largest ESOP at Cincinnati-based Procter & Gamble.

But a company culture made up of motivated workers is merely one reason to draw up an ESOP. There are major tax benefits for the employer. And these days, following a major recession, the plan might not only be a great worker recruiting tool but a retention tool as well.

“An ESOP is an extended family-owned business and you’re just extending the family,” Jochim said.

The plans typically allow workers to buy company stock at a discount or receive the stock as a bonus or stock option. A qualified retirement plan, it’s generally understood that more than half of plan assets are employer stock.

The tax factor

An ESOP is considered a powerful planning tool for business owners that rewards employee loyalty and acts as an incentive. Jochim said the plan is appropriate for nearly any type of business and there are a variety of tax benefits, including the employer’s contributions being tax deductible.

In 2007, the Employee Ownership Foundation and the University of Pennsylvania’s Center for Organizational Dynamics studied the effectiveness of ESOPs based on 30 years of research on the issue. The study, “Effects of ESOP Adoption and Employee Ownership: Thirty Years of Research and Experience,” found that employee-owned companies experience increased productivity, profitability and longevity.

Researchers at the School of Management and Labor Relations at Rutgers University, in what’s known as the most comprehensive study to date, tracked hundreds of companies that had and didn’t have an ESOP program in place between 1988 and 1994. The ESOP companies had 2.4 percent larger sales growth per year than their counterparts. And 77.9 percent of ESOP companies survived through 1996 while 62.3 percent of non-ESOP companies lasted that long.

At Dublin-based Neoprobe, the number of options available for distribution to employees is determined by its board’s compensation committee. The medical device business makes the plan available to all full-time workers, said David Bupp, CEO.

“We’ve designed our ESOP to be a long-term employee incentive, a way to retain people and recognize other contributions to the long-term performance of the company,” he said.

Neoprobe grants stock options that vest over a three-year period.

Sue Zazon, CEO of the Columbus region of FirstMerit Bank, said an ESOP also is a vehicle for a company “facing a transition in ownership.” One situation occurs, she said, when the current owner needs an exit strategy to leave the company. An ESOP creates a market for what could be non-liquid stock.

Generally, there are three viable solutions for business owners with whom Jochim consults – creating an ESOP, selling the business to a strategic buyer or, in the rare instance, taking the business public. Jochim’s rule of thumb for his business clients? “We call it the ‘no-tax solution,’ ” he said.

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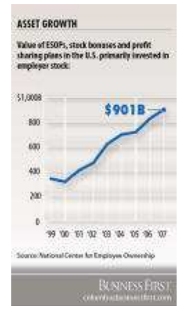

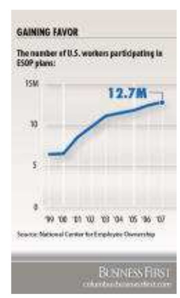

An important step a company must take to become eligible for tax-free status is that it needs to become an S Corp. In reality, the new entity is a “for profit tax exempt” enterprise, Jochim said. “It’s the best-kept secret.”

succession tactic

In 2007, the owners of Hilliard communications firm Mills James Inc. started thinking about succession planning, said Lisa Hughes, controller. When zeroing in on what they wanted to accomplish as they eased themselves out of the business, company owners “realized they wanted to give back to the employees who have been loyal to the company over the years,” she said.

Mills James’ ESOP is designed so employees become fully vested in the retirement fund at the conclusion of their sixth year of employment. Upwards of 95 percent of the employees participate, Hughes said.

“Now people feel they can contribute to the bottom line,” Hughes said. “It’s in their best interest we do well because our share value increases. Share values are tied to company performance.”

According to the Journal of Accountancy, in mature markets or economic down cycles, strategic buyers may not be available or may be unwilling to pay what a long-term owner believes the business is worth.

In addition, the synergies that make a purchase attractive to many strategic buyers generally involve consolidation, which frequently includes facility closings, discontinuation of product lines or services, layoffs, name changes and other transitional moves that operating owners find incompatible with their loyalty to other shareholders, employees, customers and communities. That’s what makes an ESOP an attractive exit option.

The journal also reports there are several things to watch out for when implementing an ESOP, including compliance requirements with the IRS and the U.S. Department of Labor.

Federal legislation is aiming to make ESOPs even more attractive for companies.

In May, H.R. 5207 was introduced into the U.S. House of Representatives to improve tax-deferred rollover provisions and repeal the 10 percent penalty tax on S Corp. distributions from current earnings.

Tami Kamin-Meyer is a freelance writer.