What you need to know

Employee Stock Ownership Plan

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Employee Stock Ownership Plan

San Francisco lawyer and economist, Louis O. Kelso, created the first employee stock ownership plan (ESOP) in 1956 as a way to transition ownership of Peninsula Newspapers, Inc. from its two founders (both then in their 80s) to their chosen successors, the managers and employees.

Kelso had long believed that the company's own employees should be the logical buyers and the ultimate owners; they were the ones who made the business successful in the first place, and the ones who knew the ins and outs of the business better than anyone else in the industry.

ESOPs have served several functions over the years, but its origin as a business succession tool is considered its most valuable contribution to the U.S. economy. Owners of privately held companies can use an ESOP to create a market for their shares, without having to sell the company to outside interests. However, the benefits of a properly implemented ESOP go beyond simple transfer of stock from owners to employees.

Fast Facts

- The ESOP is a type of employee benefit plan, similar in some ways to a traditional profit-sharing plan
- ESOPs are unique among benefit plans in their ability to borrow cash
- Management must truly be comfortable with sharing both information and decision making ability with the employees

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How ESOPs work and Tax Benefits

The ESOP is a type of employee benefit plan, similar in some ways to a traditional profit-sharing plan. The company sets up a trust fund which will contain company stock. The stock can be new stock created for the ESOP, or the trust can "buy" existing stock (such as from a departing owner). Both stock and cash contributions to the trust are tax deductible for the company.

A common funding alternative is debt, allowing the departing owner to "cash out." ESOPs are unique among benefit plans in their ability to borrow cash. The debt is paid back by the company, with both the principal and interest being a tax deductible expense.

Regardless of how the stock is put in the trust, it is subsequently distributed to the employees, either as part of their regular compensation or as a bonus. How stock is distributed is up to the company. Typically there is a vesting period for the employees similar to other types of plans; by law the vesting period cannot exceed six years.

ESOP Benefits

In addition to the company tax benefits listed above, the other remarkable benefit companies get from an ESOP is a substantial, permanent boost in productivity. Closely held, private companies show substantial growth increases in sales, employees, and most surprisingly sales dollars per employee after creating an ESOP. In addition they generally see reduced turnover and an increased ROI. However, it is important to stress these benefits do not come via the ESOP alone.

FYI

With things always changing, be sure to talk with Reilly, Penner & Benton to see the current rules, regulations and changes that may apply to you when working with an Employee Stock Ownership Plan.

It is essential that the ESOP be only part of the broader company culture. The combination of ownership and employees' participation in management is the key to any productivity growth. Implementing one without the other simply does not produce the same result. In any "Best Companies to Work For" publication you may read, you will regularly find companies that embrace employee ownership and a participative culture making the list.

Are you ready for an ESOP?

Due to the importance of the participative company culture, this is a very important question to ask yourself if you are considering starting an ESOP. If owners critical to company operations are departing, there must be a succession plan in place for a successful transition to new leadership. Management must truly be comfortable with sharing both information and decision making ability with the employees.

The company should be on a strong financial footing. An ESOP can cost up to tens of thousands of dollars to implement, and there must be free capital or solid credit to initially fund the trust. Despite occasionally making headlines in the press, an ESOP is rarely used to rescue a struggling company.