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Employee Stock Option Plans and Their Benefit for the Electrical Contractor

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Until recently, contractors were reluctant to give serious thought to turning over company ownership to employees. However, recent changes to the tax laws which became effective the first of 1985 are it in many cases making it desirable for the employee group to become the primary buyers of construction firms.

NECA has had a seminar on "Transition" for some time. This was designed to assist the owner to make plans for the transition of the firm to the next generation of owners and thereby ensure continuation of the firm beyond the business life of the owner. The use of ESOPs was not normally considered a viable tool with which to use in the transition because of the restrictions placed on them by the various laws.

Last year Congress passed the Tax Reform Act of 1984 and provided a new group of incentives for owners to sell their stock to employees stock option plans. To make these plans work, there must be available managerial talent to do the job and the owner must be willing to accept a new role. Otherwise, the plans cannot achieve their purpose.

For the owner, the new law allows him as seller to defer the capital gains taxes. Owners are allowed to use the proceeds of the sale to purchase securities of domestic corporations and roll over the cost basis into these new securities. Taxes are then paid when these securities are sold. Banks that make loans to finance ESOP purchases are allowed to exclude from their income half the interest earned. As a result, banks are offering rates based on 80% to 90% of prime. Also, payments made to the ESOP are used to pay only the principal while the interest is paid directly by the company. This means that all the payments made are from pre-tax dollars. As a result of lower interest rates and the use of pre-tax dollars, the overall cost to the ESOP is reduced by 20% to 25% based on a normal leveraged buy-out.

There are several uses for ESOPs. Under some circumstances, ESOPs can receive the stock of a deceased former employer for which it assumes that estate taxes. In the situation of multiple stockholders, the ESOP can be used to purchase the stock of one or more of the stockholders. This allows the remaining stockholders to continue the business while paying fewer net dollars. Also possible is the use of the ESOP to provide a means of additional working capital by borrowing from a financing institution and using the proceeds to purchase additional stock from the company. This gives the company some of the cheapest working capital around.

The new tax law has few other restrictions. One of the most important requires that the ESOP own a minimum of thirty per cent of the outstanding securities of the company after the transaction. Another is the restriction that no member of the sellers family as defined by the law may participate in the ESOP.

Companies are allowed to make annual pre-tax contributions to the ESOPs based on 25% of eligible compensation. This is equal to the amount allowed when both profit and pension plans are in place.

Vesting in the ESOP can be set up the same as any other tax deferred plan. Current plans can be converted to ESOPs but this is not always advantageous.

In establishing an ESOP, a company creates an incentive for the employees to work for themselves. This can backfire when company profits decline, but proper planning can overcome this obstacle. Upon retirement of an employee, the company or the ESOP is required to buy back the stock. In a successful plan, this means that a higher price is paid for the stock. When one starts this type of plan, he must realize that all his retirement funds are placed in one basket. Initially, it is unlikely that diversified investments can be afforded. However, there are no restrictions made on the investments which can be made by the ESOP.

Though Congress has made many changes to the tax laws in recent years, employee ownership of their companies seems to be encouraged. For this reason, ESOPs should be a continuing vehicle. If you are nearing retirement or thinking of selling your company, check with your tax attorney and accountants to see if ESOPs are for you. It may be one of the happier days of your life.